UNITED STATES
FEDERAL COMMUNICATIONS COMMISSION

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PUBLIC MEETING

ON HIGH-COST UNIVERSAL SERVICE SUPPORT

FOR AREAS SERVED BY RURAL CARRIERS AND RELATED

ISSUES

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FEDERAL COMMUNICATIONS COMMISSION

PUBLIC MEETING

ON HIGH-COST UNIVERSAL SERVICE SUPPORT

FOR AREAS SERVED BY RURAL CARRIERS AND RELATED ISSUES

PANEL I

SUPPORT IN AREAS SERVED BY RURAL CARRIERS AND THE DEFINITION OF "RURAL TELEPHONE COMPANY"

PANEL 2

BASIS OF SUPPORT FOR CETCs AND TRANSFERRED EXCHANGES

November 17, 2004

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* * *

COMMISSIONER ABERNATHY: My name is Kathleen Abernathy. I'm the FCC Commissioner. I want to welcome everybody to today's en banc where we are going to focus on possible reforms to the universal service support mechanism for high-cost rural areas.

As all of us recognize, universal service is one of the cornerstones of the Federal Communications policy, and Congress did make it a top priority in the 1996 Act. So, it's vital for us to ensure that the program remains sustainable over the long haul, that it operates fairly and efficiently, and that we are addressing problems before they become critical. So, what we're looking at today is how do you calculate and receive high-cost universal service support.

And the first panel will address the question of whether high-cost support for rural carriers should continue to be based on embedded costs, should be transitioned to forward-looking costs as under the non-rural support mechanism, or are there other alternatives available.

I think the Commission concluded several times in the past that a forward-looking cost methodology was an optimal choice, but refrained from implementing such an approach based on concerns about the reliability of the cost models that you would have for rural areas. And I know many of those questions remain. At the Joint Board now, we are revisiting this fundamental question, and I'm sure that our panelists will give us a lot of insight into the strengths and weaknesses of the competing proposals. What we've found is that these en banc hearings provide a unique opportunity for us to hear from all parties side by side and kind of address many of the questions that come up.

The first panel also is going to address the definition of rural carrier. Some have argued that holding companies that own and operate rural telephone companies in different parts of the United States should be required to aggregate those operations into a single study area for purposes of calculating universal service support. And essentially what we would be doing is treating these holding companies the same as non-rural carriers. So, our panelists are going to discuss the merits of the current approach, where we do not engage in that kind of analysis versus some of the potential alternatives.

Then we will have a short break. We will need a break. And then we'll move to our second panel where we're going focus primarily on the basis of support for competitive ETCs. Incumbent carriers have long argued that wireless carriers and other competitive ETCs, which is eligible telcom carriers, should receive their support based on their own embedded cost rather than on the incumbent's cost.

Competitors, by contrast, generally argue that incumbents and competitors must receive identical support, whether it's based on forward-looking costs, the lowest cost, provider's costs or any other measure. So, we're going to explore all of those arguments in detail.

And I think, in addition, the second

panel will address the FCC rule that limits support for acquired exchanges to the amount that the seller received, whether or not that should be revisited.

Now, before we get on to the substance of our first panel, I want to begin my offering a heartfelt thank you for all of our esteemed panelists for traveling to Nashville at their own expense to help the Joint Board grapple with these very, very important issues. You've given us advance presentation materials that are informative. We're going to be able to hear from you. We really do appreciate this; it's essential. We need your help as we struggle with these very complicated, complex issues. And so, thank you.

And I also want to take a moment to recognize two colleagues who are departing from public service and, as a result, from their participation on the Joint Board. It's Bob Rowe from Montana and Lila Jaber from Florida.

Bob and Lila have been part of the Joint Board since I joined a little over three years ago. They have been instrumental in helping this Joint Board, I think, cover a tremendous amount of material, controversial, complex issues that folks said we'd never be able to reach consensus on and we did.

Bob was instrumental in urging us to adopt this en banc approach, which we did. It's been very, very successful and helpful. I want to thank Bob for that, for his good humor, for his whit, his knowledge of the details. And it's going to be a loss that you will no longer be a part of the Joint Board and a loss, I think, for the public. But I wish you all the best in whatever you do next. I'm assuming we will continue to hear from you about your thoughts on many of these issues, so thank you for all your help.

And Lila also has just been a tremendous asset on this Joint Board, very good at reconciling some of the issues between the larger states, the rural states and the non-rural states, and how you balance those concerns; a friend who has helped as we've struggled through some of these issues, and who has helped me understand the workings of NARUC.

And I wish them both the best. I'm sorry they're leaving because we have a nice little family. I got very comfortable. The good news is that NARUC has nominated some excellent replacements in time for them to attend today's event. We've got Elliott Smith of Iowa. I want to thank Elliott for being willing to step into some issues and to deal with some very controversial and complex issues. They didn't tell you that, I'm sure. And Ray Baum of Oregon -- Ray, thank you, also.

They've both been nominated by NARUC. There will be a formal process through the FCC and then they will formally join the Board very soon.

And, finally, I want to give an opportunity to my colleagues to be able to talk a little bit about what we're doing here and why we're exploring these issues. And then we'll move right to the first panel.

My first colleague that I want to introduce here is via phone, and that's Jonathan Adelstein. He's a little bit busy meeting with some important folks today.

Jonathan, are you on the phone?

COMMISSIONER ADLESTEIN: I sure am. Can you hear me?

COMMISSIONER ABERNATHY: Yes. We can hear you just fine. So, if you want to make a few opening remarks, I appreciate you taking the time to get on the phone. And I'm sorry you couldn't be with us today.

COMMISSIONER ADLESTEIN: Thank you, Commissioner Abernathy. You've done a great job of organizing this, together with the Joint Board's staff, folks from the Wireline Competition Bureau here, and, of course, our excellent state staff.

I think this is a great en banc hearing you've got organized. I'm really disappointed I can't be there. I really wish I could be in Nashville today, not just because I love the Grand Ole Opry. I had my tickets; I was ready to go. But there's some pressing business here in Washington that you may have heard about that keeps me from being there. But I'm listening to as much of this by audio as I possibly can but, as you indicated, I might get called away. There's quite a few things going on here today.

I do want to join you, Chairman Abernathy, in thanking Bob Rowe and Lila Jaber for their contributions to the Joint Board. I really enjoyed working with both of them so much, and I really appreciated the expertise and the contributions that they brought to this Joint Board. They've been tremendous and we're going to miss them dearly. But I'm also very excited about working with Commissioners Smith and Baum going forward. I think they're going to make a great addition, but we'll miss our departing colleagues dearly.

I'd also like to extend a particular thanks to the remarkable group of panelists who made the time to participate today. I'm glad to see that Rich Coit will be there from South Dakota so that South Dakota will be represented even if I can't make it. All the panelists, including Rich and the others, bring a rich wealth of experience that will really enrich us on these issues. And I think together they reflect a diversity of issues that we've got to consider in this proceeding.

While the details at issue in this proceeding are really complicated, I can't overemphasize the importance of the task at hand. I've spoken a lot about these issues, and clearly Congress has recognized the importance of ensuring that we maintain a specific, sufficient, and predictable universal support mechanism. Putting that directive into concrete terms is a lot of work for us and will have an impact going forward for generations to come on the ability of providers in rural America to deliver high quality, innovative services. And it's going to affect the overall economy in development of the marketplace in those areas.

I'm really looking forward to the discussions here. What I can't hear today I'll look at the record. And, once again, I really want to send my thanks to all of you involved in the effort to put this together and tackle these important issues today.

COMMISSIONER ABERNATHY: Thank you very much. And we completely understand and, needless to say, this is just the beginning of what these issues -- it's just the opening round of comments. So, stay tuned, Jonathan, and good luck.

And, I think we'll start with you, Commissioner Martin.

COMMISSIONER MARTIN: Thank you. Thank you for organizing the panel and thank all the panelists for making the trip all of the way out here and for extending their stay here at NARUC.

I also do want to thank and begin by recognizing the efforts of Bob Rowe and Lila Jaber over the last few years. They've certainly been instrumental in a lot of the decisions we've done. I personally have benefitted greatly from their insight and their wisdom as we try to address several of these contentious issues. And I think they've done a pretty good job of public service, not only on this Joint Board but in serving the citizens of their states and serving all of the citizens in the country by their efforts here. So, I do want to wish them the best of luck, and we'll continue to miss both of you as we go forward.

As Jonathan mentioned, Congress has required the Commission to ensure that we have a sufficient universal service support mechanism to make sure that all of rural America and all of rural Americans have the ability to obtain service at rates that are relatively comparable to those of citizens living in urban areas. And I think that one of the core goals during my time at the Commission has been to ensure that we have the connectivity to the 21st century networks for all Americans, including those who live in rural areas.

Today's en banc is certainly going to address some of the contentious and critical issues for how we go about achieving that goal and the future of universal service and the support for those networks.

As I have said before and in private meetings with many of you and in some of my previous statements, I do have concerns and am troubled by some of the Commission's potential to request that the Joint Board consider whether a forward-looking economic cost model is more appropriate than for high cost and for non-rural telephone companies. When the Commission explicitly adopted that mechanism for the non-rural companies, they explicitly stated that might not be an appropriate mechanism for rural companies.

And, indeed, the Rural Task Force has made clear that -- one of their cornerstone concepts of their recommendation was the decision to recommend the continued use of the embedded cost mechanism rather than the Commission's forward-looking cost model for sizing universal support for rural carriers. And I continue to be concerned about the implications for them.

So, I'm anxious to have the dialogue with the panel today to further understand their views and the options of the Commission. And I equally think that the second panel with regard to ETCs will be an important discussion for the Joint Board. Again, I think that many of the issues related to the ETCs have been widely discussed among the Joint Board, and I think there's many concerns about the level of scrutiny that the Commission should be applying to the ETCs and also how we should be distributing resources there as well. So, I think we will have a spirited, I'm sure, debate on the first and second panel.

With that, I'll turn it over to my other colleagues.

COMMISSIONER ABERNATHY: Thank you, Commissioner Martin.

Now, we'll hear from Commissioner Dunleavy.

COMMISSIONER DUNLEAVY: Thank you very much, Madam Chairman.

And I'd like to echo, of course, Commissioner Abernathy comment's and Commissioner Adelstein's comments and Commissioner Martin's comments relative to the contributions that were made by both Bob Rowe and Lila Jaber. I'll tell you that I for one will sorely miss the good counsel and help that was provided so freely and generously on every question. They were never too busy to help out wherever they were asked. They will be sorely missed.

And I think we are, likewise, very fortunate to have the opportunity to be joined here by Elliott Smith from Iowa, who is doing a bang-up job on the ICC task force for the telcom committee and NARUC; and, of course, Ray Baum, who will bring -- who does bring a tremendous amount to the table.

Lila and Bob are big shoes to fill, but I'm sure that over time that that will --

COMMISSIONER JABER: His are bigger.

COMMISSIONER DUNLEAVY: -- that will take place.

In any event, I think that it probably goes without saying that none of us here today questions the importance of universal service and the issues before us. I'm sure, too, that we would all agree that our goal is, as the Act directs us, to ensure that comparable telcommunications services are available in all regions of the country at reasonably comparable rates.

Now, we might even all agree that we want new telcommunications capabilities, new technology to become available in all areas in a very timely fashion. Those are all in agreement. And there is, as we have heard repeatedly at a variety of meetings and panels at the NARUC convention during the week, that there is a growing concern over the sustainability of the current universal service regime in general and its high-cost mechanism in particular. And this suggests to me that perhaps more of the same is simply not an acceptable answer. Therefore, we're going to need to find and agree on a new approach to achieving our common goal.

Now, unfortunately, after reviewing the positions offered and the comments in this proceeding and the statements of -- some statements of some of our panelists, I sense that we haven't yet made great progress towards finding and agreeing on any new approaches. Indeed, I have the sense that we don't even agree on the role high-cost support should play in achieving universal service.

And so, I sincerely hope that today's en banc will give us the opportunity to find and explore some new ideas. And I hope that instead of what so often happens here in our world that instead of finger pointing and name calling, that we could use our limited time together to discover areas of agreement that will help all of us along our path to universal service reform and achievement of all of our common goals.

And now, in the interest of

preserving time and knowing that I've already said too much, I will thank you, Madam Chairman, and turn it over.

COMMISSIONER ABERNATHY: And now I want to welcome Commissioner Bob Nelson to his first en banc. Thanks for joining us. He's been, already, an important part of the team as we prepared for this proceeding.

COMMISSIONER NELSON: Thank you. And I do also want to extend my remarks regarding Lila Jaber and Bob Rowe. I echo the sentiments of Commissioners Abernathy, Martin, Adelstein, and Dunleavy. They led the way for me and others to join this Joint Board, including Elliott Smith and Ray Baum, and have set very fine examples for us to follow.

In terms of what we're going to be hearing today, I agree with Tom that, you know, perhaps the written comments so far have not coalesced behind a unified approach to the issues that have been teed up in this proceeding. But I am certainly eager to hear the thoughts of the panelists today regarding the sustainability of the high-cost fund and how that can be best addressed through the goals that we're offering today.

So, with that, I'll close my remarks.

COMMISSIONER ABERNATHY: And now we'll hear from Billy Jack Gregg, Consumer Advocate from West Virginia.

CONSUMER ADVOCATE GREGG: Ditto to Bob and Lila. Good luck, God speed in your transition to civilian life.

In my entire time on the Joint Board the issues that we faced remain the same. It's whether we're going to support access or excess. Unlike my fellow commissioners, when I read the comments, I did see a broad agreement among the parties. It was that there is abuse in the system, and it's the support that the other guy is getting.

I hope that as we talk about trying to harmonize the currently existing rural and non-rural support mechanisms, that we don't lose sight of the more distant future and what an appropriate universal service support system will be in a broadband age that is rapidly coming down upon us. And I'm going to take any opportunities I have today to elicit suggestions from the panelists on steps we can start to take now to transition the universal service fund to one that will be appropriate in the broadband age. Thank you.

COMMISSIONER ABERNATHY: Thank you very much, Billy Jack.

And then finally we'll hear from Commissioner Lila Jaber from Florida.

COMMISSIONER JABER: Thank you, Commissioner.

I think that I can take the liberty and speak on Bob's behalf as well -- Commissioner Rowe's behalf that this is an awesome body that has been led by a fantastic manager/leader in Kathleen Abernathy. I think Bob and I can attest to the fact that certainly the criticism that the Joint Board moves slow has been put to bed under your leadership, Kathleen. And I just want to stop and recognize you for your incredible ability to have the body reach consensus when we could reach consensus and be concise about the areas that we just simply disagree on in a manner that is timely and that has afforded an opportunity for folks to respond to different options that we put on the table. And I give you complete credit for that.

And I also want to recognize Commissioners Martin and Adelstein for their incredible ability to have us think through very tough issues. And, frankly, this topic in particular, both Kevin and Jonathan have been voices and, before you, Commissioner Copps, who started out on the board when I got on the board and Bob was on the board -- just for your thoughtful, deliberative manner and requesting that we think through all issues and being the voices of reason when we desperately needed that.

This is an incredible opportunity, commissioners and folks in the audience, to think ahead while times that -- there are state commissioners leaving. And, certainly, Bob and I will miss our state colleagues on the Joint Board and we recognize you for your effort. I see it as a fantastic opportunity to move forward. And I think Elliott and Ray are two people that can help in that regard and my compliments to the selection.

But I also think it's an opportunity to move the universal service program forward.

Like all things in all programs, certainly government-type programs, there are inefficiencies that have to be addressed. That's not to take away from the success of the program. Billy Jack referenced that a little bit earlier, that we have heard that there are reforms, and certainly we see directly that there are reforms that need to take place. And we are excited today to hear what those reforms should be.

But I hope we also remember that this is a well-founded, successful program that needs to be improved upon and become even more sustainable. And the questions I have today really go toward trying to figure out what these improvements are. In my questions, you'll see a theme. I'm really focused on the definition of a rural telephone company and how that plays a part in this debate going forward.

My compliments, again, to the entire group. I wish you the best of luck and I hope our paths cross again in some form or fashion. We'll see you soon.

COMMISSIONER ABERNATHY: Thank you

very much, Commissioner Jaber.

And now we'll move toward to the panel. I want to emphasize what we would love, because we do have your written materials, which we have reviewed. If you could keep it down to three minutes, which I know is really tough -- but that's because we do want to hear them all, but we want to direct specific questions at you.

If you could also go ahead -- we'll start with Rich Coit and work our way down the line. If you go ahead and introduce yourself very briefly, make your presentation. And then as questions are asked, if you could identify yourself, because we have a record that's going to go into the docket. And we want to be able to identify which parties are supporting various proposals.

So, we'll start with Rich Coit of South Dakota Telcommunications Association.

MR. COIT: Thank you, Madam Chairman, members of the committee -- or the board. I would just like to thank you for inviting me today. I look at this as an honor. And I think, looking at other members of the panel, we will have a great discussion today. And hopefully we'll get closer to where we need to be to get to where we need to be in the future.

I would just like to spend just a few minutes here just giving you a little background. I am here today representing the South Dakota Telcommunications Association and also the National Telephone Cooperative Association.

With respect to SDTA, as an organization, currently we have 29 member companies, all of which are rural telephone companies. Twelve of those companies are member-owned cooperatives, and 13 of those companies we would consider private companies, companies that are either owned by family businesses -- some of those companies are also owned by some of the cooperatives, are subsidiaries of some of the cooperatives.

We have three municipal telephone companies that are members, and we also have a tribally owned telephone company, Cheyenne River Sioux Tribe Telephone Authority.

In terms of the service that those

companies provide in South Dakota, they serve approximately 152,000 access lines spread across 61,000 square miles of South Dakota. That accounts for approximately 75 to 80 percent of the state's geography. And our companies serve all or part of eight of nine Native American reservations in South Dakota.

To give you an idea of the true rural nature of the companies, the three largest communities served by the SDTA member companies are Brookings, South Dakota, which is a town in the eastern part of the state with a population of about 18,504; Hot Springs with a population of 4,129. And the third largest is Winter, South Dakota, with a population of 3,137. So, that will give you an idea of the types of communities we serve.

Obviously, our companies serve incorporated and unincorporated communities. Some of the unincorporated communities, they probably don't even have populations of 20. So, we are very sparse in terms of the area that we serve. Looking at the population density of the counties that are served by SDTA member companies, the average density is four persons per square mile. Eleven of those counties have less than two persons per square mile.

As a group of companies, as someone who's been involved in the telcommunications industry and the rural industry in South Dakota for a fair number of years, I can say that we're proud as an industry of the investments that the rural carriers have made in South Dakota.

As a group, they've deployed almost 6,000 miles of fiber across the state, which includes a backbone network today utilizing SONET and EWEM technology. These facilities have allowed us to extend frame relay and ATM services to any requesting school in our service areas. That was done in large part in partnership with the Digital Dakota Network, which is an entity, a network, of leased facilities established by the State of South Dakota for use by schools throughout the state.

We have -- looking at the local facilities' deployment, local exchange facilities' deployment, any upgrades of the loop facilities over the past five or six years or so, we have been able to reach 250 communities with DSL services. VDSL is also now available in more than 50 of those communities.

There are a number of issues that are before the board today. I suspect that probably much of the discussion will be on forward-looking cost models versus embedded cost models. As you can tell from our written comments, we have indicated support for the embedded cost models. We've -- you will hear challenges today to -- and criticisms of both of those methods, and I would just ask the Joint Board as you evaluate those criticisms, evaluate alternatives to address the issues that are presented -- first and foremost, we believe that the Joint Board needs to, whatever it adopts, adopt a mechanism that is consistent with promoting continued infrastructure investment.

If you look at the current method this is utilized, we believe it certainly has been consistent with that. In looking at all the investment that has been made in South

Dakota, I think in large part we've been able to do what we've done as a result of the mechanisms that are in place today. So, in our view, looking at -- you know, there are standards in the Act: specific, sufficient, predictable. But first and foremost, look at what the impact on the investment is going to be, because if you don't have that investment, that continued investment, you're certainly not going to be able to preserve advanced universal service, which is the general goal that's set forth in the Act. Thank you very much.

COMMISSIONER ABERNATHY: Very good. Thank you very much.

Now, we'll move on to Paul Garnett from the CTIA.

MR. GARNETT: My name is Paul Garnett from CTIA. We represent, as you know, all of the major providers of mobile wireless services in this country in addition to a number of small- and medium-sized carriers, manufacturers and applications providers.

First of all, I'd like to thank the Joint Board for including CTIA on this panel.

Increasingly, the wireless industry is contributing to the universal service mechanisms, and we also increasingly are receiving high-cost support. So, we feel it's important that we be included in whatever debate there is about the future of the high-cost support mechanisms and other universal service debates.

CTIA and its member companies think that this proceeding along high-cost and contribution-related proceedings and the intercarrier compensation proceeding together, will have a significant impact on the way services -- first of all, whether and how services are deployed, both information services and telcommunications services are deployed in rural areas in the foreseeable future. So, you have a significant task before you.

In our comments CTIA has presented a proposal for reforming the high-cost mechanisms. And in developing that proposal, we tried to do exactly what Billy Jack Gregg described, which is to really try to have as long a time period, as long a horizon as possible in developing those proposals; not to just look at what the high-cost mechanisms should look like in the next couple years, but what the mechanisms potentially should look like ten years from now when we really have a different industry.

And we considered a lot of different things. We considered keeping the embedded cost system, competitive bidding, direct consumer subsidy, forward-looking cost. We considered all those things, and we sat down with our member companies over a series of calls, just like I know you will go through this process on Joint Board calls and among yourselves, tried to come up with a proposal that basically moves us forward into the future and has a mechanism in place that basically accommodates what's been happening in the industry.

Taking a step back, in developing our proposal, we looked first at the Act, which requires that the support mechanisms be -- as you have all mentioned -- predictable, sufficient, specific; that the mechanisms focus on consumers first and foremost; and ensure that consumers in rural high-cost areas have access to the same types of services and the same options that are available to consumers in low-cost urban areas.

Beyond the basic framework provided in the Act, we also came to agreement on some core principles for reform. The first thing that we agreed on is that whatever system is in place needs to be administratively as simple as possible. We all agreed that the current system has way too much administrative complexity. The second thing we agreed on is that whatever system is in place must encourage and reward efficiency over time. And thirdly, we agreed that whatever system is in place has to appropriately target support to high-cost areas. It's not enough for the mechanisms to calculate what may on average be high cost. You have to make sure that the support, whatever it is, actually gets spent and targeted to those high-cost areas that need it.

So, with that in mind and having considered a whole number of possibilities, we ultimately agreed that the best system for achieving those goals is one based on forward-looking economic cost, which is what the Commission and the Joint Board has come to agreement on in several instances in the past.

So, here's our proposal. Basically, the way we have laid it out in our comments is that over time we transition from our current system of five high-cost support mechanisms plus two derivative high-cost mechanisms created under the high-cost loop mechanism down to one high-cost mechanism that calculates support based on forward-looking economic costs. That mechanism would target support to wire centers. Initially, it would base support for both incumbents and competitive ETCs on the incumbent LEC's forward-looking cost for a specific wire center. Ultimately, you would develop a mechanism that would calculate support for specific areas based on the most efficient technology in that specific geographic area, whether that's wireless or wireline or whatever.

Under whatever mechanism is in place, though, we think it's critical that equal per-line support be available on a non-discriminatory basis. So, whatever the support is based on, whether on wireless costs or on wireline costs, support should be equal.

How do we get there? It's not something that would happen overnight. It would have to happen over a number of years. We would transition, first, big carriers to the forward-looking support mechanism. We would need to make a number of changes to the forward-looking mechanism in order to get smaller carriers on it. We would have to get rid of state-wide averaging, change the benchmarks possibly.

But two things that definitely will need to happen in order to get us there, first of all, the Joint Board and the Commission are going to have to devote resources to making this happen. And I think one of the big knocks on the forward-looking mechanism in the past is that the Commission did not devote appropriate resources to keeping that mechanism up-to-date and keeping inputs to the mechanism up-to-date. The rules should be codified to require frequent updates to the mechanism, whatever it is. And the Commission needs to set firm deadlines for that transition.

And we look forward to discussing this proposal further with you.

COMMISSIONER ABERNATHY: Thank you very much, Paul.

And now we'll move on to Jeff Reynolds of Parrish, Blessing, and Associates.

MR. REYNOLDS: Good afternoon. My name is Jeffrey Reynolds. I'm a principal in the economic consulting firm of Parrish, Blessing, and Associates and testifying today on behalf of the Independent Telephone and Telcommunications Alliance. ITTA is an organization of mid-sized telephone companies serving thousands of rural communities. ITTA member companies serve a large proportion of the rural lines in the nation.

ITTA appreciates the opportunity to offer this testimony on the continuing need to provide specific, predictable, and sufficient universal service, high-cost support for rural carriers. ITTA urges you to recommend that the FCC continue to use the statutory definition of rural telephone company to determine eligibility for high-cost support. ITTA advocates that the FCC continue to calculate support on a study-area basis for rural telephone companies. ITTA also asks you to recommend retaining the use of embedded actual cost in calculating support level for rural carriers.

The use of the statutory definition of rural telephone company to determine eligibility for rural universal service support has worked well. This definition contains multiple criteria for a reason. No single attribute could adequately define carriers serving rural areas. The record in this proceeding confirms that rural areas should be treated differently than non-rural areas. There also are substantial differences among rural areas. Study areas served by rural carriers vary significantly in many aspects, including line density, topography, and demographics. Because of this, use of the definition of rural telephone company under the Act reflects and captures the variability of these markets better than any single test would.

Further, there is no compelling reason to change this definition. Such a change in eligibility likely would cause certain rural carriers and the communities and customers they serve to lose substantial support. Considering the many comprehensive reform measures currently before the FCC, this is not the time to make radical changes to universal service support eligibility rules.

In addition to considering major changes to the current system of universal service support, the FCC is considering comprehensive reform to intercarrier compensation. This proceeding will disproportionately affect rural carriers. The Joint Board must account for these shifts before advocating any piecemeal changes to the rural universal service fund eligibility and calculation rules. The Joint Board should take care not to exacerbate the volatile regulatory environment already faced by rural carriers.

Similarly, the Joint Board should reject proposals to require carriers owned in a holding company structure to average their costs holding-company wide or statewide. By averaging costs across rural and non-rural study areas, many study areas suddenly would no longer qualify for high-cost loop support. In other words, a rural study area could lose its high-cost funding simply because it is served by a telephone company that has non-rural affiliates. Moreover, any averaging approach to a cost-recovery mechanism creates implicit subsidies and/or significant increases in rates in rural areas. Either result would be contrary to the goals of section 254 of the Communications Act and work to the detriment of rural consumers.

This proposed change also would encourage holding companies that through their operating subsidiaries serve both rural and non-rural areas to sell off non-rural exchanges. Such fractionalization of the industry would destroy efficiencies that cannot be matched by stand-alone telephone companies. The current system fully captures the scale economies of holding companies. These efficiencies lower the company's reportable costs for universal service support purposes and reduce demand on the high-cost fund.

Finally, ITTA advocates that rural universal service continue to be calculated using embedded costs and not a forward-looking model. The embedded-cost mechanism is the most precise method for determining network cost. The differences between rural and non-rural carriers make it problematic to apply a forward-looking high-cost support mechanism to rural carriers. The distortions caused by a forward-looking cost models are far less in the more homogenous non-rural areas. The dislocations that have been demonstrated in rural areas by using a forward-looking model would produce disastrous decreases in funding in rural areas.

There is good reason why the FCC has twice declined to adopt the forward-looking economic cost model for rural carriers. The Joint Board should recommend that the FCC once again reject the movement away from embedded costs. Thank you.

COMMISSIONER ABERNATHY: Thank you very much, Mr. Reynolds.

And now we will hear from Joel Lubin, who is with AT&T.

MR. LUBIN: Thank you very much. Good afternoon. I want to thank members of the Joint Board for putting the hearing together and allowing me to participate on the panel.

Before I address the questions asked by the panel, I'd like to put some issues in this proceeding in perspective. I'm going to attempt to do that and summarize it in three minutes, if I can.

Let me begin and talk about the issue of rural versus non-rural in terms of the cost methodology. As an individual who participated in the Rural Task Force for about 27 months, I learned a lot. And what I learned at that point in time is that it's extremely difficult to create a forward-looking costing tool when you're dealing with a thousand study areas, or 1200 or 1300 study areas. The record currently is overwhelmed with information and data that suggests the dilemma. I'm not saying it can't be solved, but if it is going to be solved, you're going to have to spend a tremendous amount of resources and a tremendous amount of time. Up to this point in time, I have not seen that.

Point number two, before we harmonize the issues of costing between rural and non-rural, from my point of view, I think there is something even more important that requires harmonization. And that is the patchwork quilt of all forms of intercarrier compensation methods. From my point of view, I believe the intercarrier compensation issues need to be addressed, have to be addressed, and they can be addressed. I couple that with universal service reform as well.

And the reason why I believe it is so important is because, A, it's broken; and, B, depending on how that gets changed, it will affect how you answer the questions that are before you today. It could, in fact, eliminate the need for the questions to be answered or, clearly, if they still need to be answered, the way in which you solve it would in my opinion be fundamentally different.

Second point is there's another

docket -- I guess it's the next panel on eligible telcommunications carrier. There again, I think you have to wait before you answer some these questions until you see the outcome of that docket. My company has put forward the concept -- and it's in the record of other carriers or participants, as well -- of identifying a benchmark. That is to say, over some level of subsidy that you obtain in a particular geography, you conclude that you only want to have one ETC. If you only have one ETC, the question then becomes, is it critical to have a TELRIC method for that one ETC in that area if you're not going to have multiple ETCs.

The other thing that I heard today and is also in the record is this concept of infrastructure. I think that code word for infrastructure, as I understand it, is a code word of we are in a circuit-switch world moving to an IP world. And as we move from a circuit-switch world to an IP world, I assume incumbents want to ensure that the money that they're getting in a circuit-based world will still be potentially available in an IP world.

I think that's a very legitimate question to be looked at.

I also hear Billy Jack Gregg raise the issue of where are we going in the future with broadband. I think that's another critical point that also has to get addressed. And it also fits in with the whole infrastructure question. And the reason why I perceive it to be important is depending on how this evolves, it's going to again help begin to answer how these questions should be answered and how one transitions the answers to these questions in terms of operational plans.

And I'll even just go one step further. If we're talking about infrastructure ultimately being supported by universal service and we're ultimately talking about a broadband pipe into the home, then the question ultimately comes to how many broadband types are you willing to subsidize into the home. And so, I would hope we don't take legacy solutions and try to superimpose them in the new world. So, my bottom line is I would hope that the Joint Board should proceed very cautiously with their investigation, and it should certainly not require devotion of resources, whether they be state, federal, or industry resources, prior to an order on intercarrier compensation and a Commission order on ETC designation.

Thank you, and I'll be glad to respond to questions.

COMMISSIONER ABERNATHY: Thank you very much, Mr. Lubin. That was great.

Now, we'll hear from Mr. Weller with Verizon.

MR. WELLER: Thank you, Madam Chairman, and commissioners for the opportunity to speak you today. My name is Dennis Weller. As you just heard, I'm with Verizon.

I think that we've all been reminded, if we perhaps needed to be, by the recent flap over accounting rules at USAC of the fact that we're basically skating on the outer of limit of what is possible for support in terms of the overall size of the federal mechanisms using any carrier contribution mechanisms and not emphasize any -- I think if we do long division by revenues or by connections or by phone numbers, we still have a concern. There's no magic wand that's going to solve that funding dilemma, getting the same money essentially to the same people.

That constraint being there, I think we need to consider our main focus in the near terms as controlling the size of the fund and the measures that ensure incentives for operating efficiently, that deal with costs of duplication of supporting multiple networks, and that also prevent us from expanding without meaning to the entitlement that we offer to consumers in rural areas in changing the kinds of services that they can buy. We've made four recommendations that deal specifically with those concerns, and I'll just list them quickly here.

First, we recommend that the FCC should establish a rebuttable presumption that there should be only one ETC in each rural serving area.

Second, in areas where that presumption's overcome and for whatever reason they have more than one ETC, we need a second line of defense, another control mechanism. We propose that that should be a primary line approach that essentially de-couples the carrier's -- the customer's purchase decision from how much subsidy they get, which I think we need to do to avoid having somebody go from, say, one wireline line to adding, say, five wireless handsets. And so, $20 in subsidies turn into $120 of subsidies.

The third measure that we would propose is that at the outset of any new plan, the support level should be based on the incumbent carrier's actual expenditures during the previous 12-month period rather than on some level it's already cost us. However, that should only be done once going forward. And then that should be frozen and then indexed so as to provide an incentive to all ETCs in each area to operate efficiently.

And, finally, fourth, I think we need to recognize that the larger carriers in rural areas providing universal service have characteristics in terms of density, investment per line, portion of business customers in the area, and so on, that really make them much more similar to the non-rural carriers than they are to the smaller carriers in rural areas.

And so, it makes more sense, we feel, to consolidate study areas within each state than on a consolidated basis that a carrier that's serving more than 100,000 lines in a given state ought to be treated the same way as non-rural areas are.

Those are specific proposals. You'll notice we provide incentives for efficiency without going through what I think will be the agony of developing a new cost model or arguing about the inevitable errors in such a mechanism.

I would also caution, given the premise in which I started, in trying to export the problems of the intercarrier compensation world into this world where we're already having enough problems dealing with the difficulties we're facing here already.

And, finally, in conclusion, I'd like to turn to the question that Billy Jack Gregg asked, which is, what do we do about universal service in a broadband age. And my answer to that is something completely different. I don't think we should kid ourselves that the near-term proposals that we're talking about in these open proceedings are policy for the ages or that they're going to survive more than about, say, five years in the face of changes I think we can all see coming.

I'm just going to list three of those changes very quickly, and I invite your questions during the remainder of the session.

First, we're all transitioning, we're all building IP-based networks. So, as we do that, we're going to exchange traffic, we're all going to play by Internet rules, not by the old circuit switch rules. Those new networks and that change in the market is good for the consumers. It's going to offer them many more choices. But as a side effect, it's going turn rural ILECs from net recipients of access service to net payers of transit service to interconnect with Internet backbones.

Again, that's not a market solution that we ought to try to change, but we need to take account of it in considering what the requirements are going to be to meet our universal service goals in the future.

Secondly, in terms of contribution, simply put, we have a sector-specific approach to contribution today, or certain contributions from certain carriers. We're one of only a handful of countries around the world to try to do that. Most countries do it out of general revenue. And by that, I don't mean state plus interstate telcom revenue; I mean the federal budget. A sector-specific tax works if you can identify the sector. Going forward as the telcom sector emerges with a larger Internet, we're not going to be able to do that and we're not going to tax the larger Internet as whole. So, we have to work through another funding source. That may be painful but I think this may be like democracy in that it's the worse solution except for all the others.

And, finally, we have a certain notion of how the universal service funding mechanism works. Money goes into a fund, comes out of a fund in terms of monthly checks. The checks supported a fine, local service. And I think all of that framework is going to be rethought for the future.

If I have a broadband connection to the world, I may get my voice application from anyone. It could be a VoIP provider in Estonia. Unless we want to get into the business of having USAC send checks to Estonia, we probably need to rethink the structure of that. We probably need to start funding infrastructure more directly, perhaps through up-front grants. One advantage of that, I think, also is it decouples the decision of what to support from the decision about what to regulate. And I don't mean to give you the answer to either of those, but I suggest those decisions ought to be made independently.

So, with that, I'll stop. And I invite your questions. Thank you.

COMMISSIONER ABERNATHY: Thank you very much, Mr. Weller.

And now, Mr. Dale Lehman from the Alaska Pacific University. You probably came the furthest. Thanks.

DR. LEHMAN: Probably flew the most

hours, I think, yes.

Thank you for the opportunity to come and participate in this panel. I don't believe this panel exists because of the theoretical differences between forward-looking and embedded costs. I do believe this panel exists because embedded costs have a unique property in that they are intimately tied to the actual costs of providing universal service. And only forward-looking costs provide the basis for creating an illusion that somehow universal service can be provided far more cheaply than it is today. And I think that that illusion is produced in three fundamentally flawed ways, all of which have been provided to you in various pieces of testimony.

One is this vision that somehow the rural ILECs' costs are rapidly increasing. In fact, they have pretty much matched inflation on a cost-per-line basis. And I think the best benchmark to compare that to is states' own price cap proceedings in which 38 states, their average X factor for productivity they expect in a local exchange pretty much matches the inflation rate, which is what the high-cost fund is also matching.

The growth in the high-cost funds, which undeniably has been large in the last five years, has been due primarily to a restructuring from implicit to explicit support, to some extent to the acquisition of rural exchanges from larger carriers and subsequent investment, to some extent through the re-initializing of the cap that was in place over the 1990s, and a very slight extent to an increase in lines. But it's not that the cost -- the cost per line has not been increasing dramatically. So, it's an illusion to think that there's some waste that's occurring suddenly in the last five years. It was either there all along or it hasn't been occurring.

The second is this perception, the allegation of systematic waste and inefficiency that goes on. And I think the only evidence that's been provided of systematic inefficiency concerns the issue of the number of rural carriers and whether massive consolidation would, in fact, be a good idea. And I suspect we may have some more discussion of this, but I would just point out that I don't think -- I think the cost savings are unproven and, in any case, I think it is a very bad idea for rural areas to think that you should be urging a massive consolidation of rural telephone companies.

The third illusion of waste that goes on is probably the most disturbing. And that's this vision that technology is changing and somehow it has dramatically reduced the cost of providing universal service. I don't think that comports with the facts on the ground with the exception of possibly switching. Loop costs have not experienced that kind of technological progress. And what's more troublesome is if you really believe it has, we should be talking about a different issue that's hardly been raised.

And that's that if carriers made prudent investments in the past when technology was different and now technology has rendered the costs far lower than what they already spent, they have under-recovered those investments to this point in time, and we need to be talking about how to make them whole in the sense of the prudent investments they made in the past. And this is important in a forward-looking sense because future investment in rural areas depends on how you treat the investments that were already made in rural areas.

So, if you really believe that technology has made the current technology obsolete, we should be talking about how do we ensure that carriers have an incentive going forward to invest in the next generation of technology, which will also be made obsolete at some time in the future.

And, finally, I would say that I think I agree with a couple of things that I heard, that the choice of embedded costs and forward-looking cost really shouldn't divert you from far more important issues. And I think intercarrier compensation, how to fund competitive, eligible telcommunications carriers, as well as the contribution that comes in for USF are far more important and far more worthy of your time than chasing after a forward-looking cost standard.

Thank you.

COMMISSIONER ABERNATHY: Thank you very much, Dr. Lehman.

And, last but not least, Dr. Lee Selwyn will be giving us a presentation from Economics and Technology, Inc.

Thank you, Dr. Selwyn.

DR. SELWYN: Good afternoon, commissioners. Thank you for the opportunity to speak with you this afternoon. I will summarize my written statement emphasizing a couple of key points.

I think that the policy that has been developed over the years, and you heard a lot of it in the remarks so far this afternoon, has been focused on rural carriers. I believe that fundamentally universal service policy has to be focused on consumers. And consumers' interests may not coincide precisely with the service providers that serve these areas. Consumers' interest -- and, incidentally, consumer interests come both with respect to rural consumers as well as consumers in non-rural areas who are being asked to contribute to the high-cost funding mechanism.

For the consumers who contribute, obviously, as the total size of the fund escalates and their surcharges continue to rise, that's clearly a concern. But for consumers in rural areas, if the size of the fund continues to escalate at the rate at which it has been escalating in recent years, the political basis for continuing this support mechanism could well erode. And the very fact that some of the discussions that we are having here today are taking place is evidence of that. And that is not necessarily in the interest of rural consumers who are looking for ways to assure that service is available in their community.

Second point is that there's been some discussion about the effect of CETCs entering in rural areas, getting certification, and drawing funds from the high-cost support mechanisms. Concerns are expressed that if CETCs erode rural LEC revenues, causing -- further escalating the size of the fund and not allowing the rural LECs to shed costs as rapidly as they might be shedding revenues.

Interestingly, these are not new arguments. We've heard these arguments. I've been involved in this field now for 30-some-odd years, and we've heard these arguments at every stage of the entry of competition into almost every sector of the telcom industry. And this is simply the latest incarnation.

If we have a national commitment to competition, I don't think it's appropriate to carve out certain segments of the country and simply declare competition as nonfeasible and not to be supported. If we subsidize incumbents and do not subsidize competitors serving the same types of customers in the same areas, we create very perverse incentives. We deny customers in those communities access potentially to more efficient, lower cost, and perhaps more functional -- more highly functional technologies and alternate services. It's hard for a competitor to come in and compete with a subsidized incumbent. It's hard enough for a competitor to compete with an incumbent.

If the incumbent is subsidized, it may make entry almost impossible.

Competition at a certain level is going to happen as we move more toward broadband. Intermodal competition that the Commission has expressed such interest in in recent years in other fora, it will come to rural areas. And rather than bury our heads in the sand and assume it won't have any effect as long as the CETCs as are excluded from the subsidy mechanism or CLECs are not certified and therefore do not receive subsidy, there will continue to be revenue erosion.

With respect to the issue of embedded versus forward-looking costs, years ago all local exchange carriers were regulated on the basis of embedded cost under a system regulation known as rate-of-return regulation. At that time, the carriers would submit extensive rate cases, sometimes 15 or 20 or 25 witnesses, extensive financial and other data. Commissions would review this, would determine the legitimacy of investments, legitimacy of various operating expenses, would conduct audits and reach conclusions as to the overall revenue requirement. They would consider all sources of revenue that were available to the LEC.

When we speak of embedded costs in the context of rural carriers -- and the notion that these somehow are actual costs, I think raises some serious question. Nobody is really looking at these costs. They may be -- they may not have increased in inefficiency, but they certainly have an incentive to continue to escalate spending and escalate their operating costs if they can be assured reimbursement.

It seems to me what we need to move to is a system that will eliminate perverse incentives, that will eliminate incentives of larger carriers to sell off smaller exchanges because they have been able to access more high-cost support incentives that would favor incumbent technology and incumbent carriers over entrance. And, as a general matter, doing these things will make -- will really satisfy and achieve the goals of the Telcom Act, which is to give to rural communities access to the same and equivalent services that are available in urban areas and at prices that ultimately will come to be comparable to those available in non-rural areas.

Thank you. And I'd be happy to respond to any questions.

COMMISSIONER ABERNATHY: I want to thank all our panelists. You did exactly what we asked you, to give us a high-level summary, raise a lot of questions.

So, I think what I'll do is for the first round we'll start to my right. We'll start out with Commissioner Jaber, and then on down to Commissioner Martin. And because we've got enough time, I think each commissioner can go with two questions. If we still have time after that, we'll do another run.

COMMISSIONER JABER: Let me seek your guidance, Madam Chairman. I have a question that I would like to pose to any panelist who wants to comment on it. And then I have a second specific question.

The first one is as I said in the

introduction. I want to focus a little bit on the definition of the rural telephone company. And I heard panelists specifically address that.

Mr. Coit, you took a specific position on it. And my question to you, and then generally to the panelists, is I think that there's recognition that some carriers are receiving support from the program having met the definition of rural telcommunications carrier company, but yet serve in a non-rural area. In my state, in particular, I know of one that is in the Disney area. Disney is not rural in Florida. I pose that to anyone who wants to comment on it.

And then, Dr. Lehman, my question to you is one that comes from confusion and I apologize for that. I'm not sure if you were advocating that we go back and make companies whole by doing rate cases. When you referenced, you said that perhaps it's a question of these incumbents who have not fully recovered the cost of infrastructure. All I could think of was, are you advocating for rate cases?

DR. LEHMAN: No. I think the rate case is an inefficient way to go about that. But I think the point is if the money was already spent and it was spent when newer technology that is presumably much cheaper -- which I actually don't accept as far as loop access goes -- but if that's your premise, then it's much cheaper, to provide access to loop facilities. The money was well spent in the past, but it hasn't yet been recovered. You can't just sort of pull out and say, oh, well, the cost has gone down so now you get half of what you got before. Because the next round, nobody is going to invest in the newest technology without a much more accelerated fashion of recovery.

In some sense, it means the depreciation was inadequate in the past because we're now saying the economic reality is these facilities really don't have much of a life left or don't have much value left. But you're stuck with them on the books because the world has changed, not unlike stranded costs in electrics, which I know you have a lot of experience dealing with. And generally the principle has been accepted that stranded costs are an issue that needs to be dealt with. I think there is a huge stranded cost issue in telcommunications if you believe the premise that costs have dramatically come down.

COMMISSIONER ABERNATHY: Go ahead, Dr. Selwyn.

DR. SELWYN: We don't know that those costs haven't been recovered because we don't have any traditional rate of return analysis of revenues and costs. What we have is a funding mechanism that is sort of cost driven, but is not really focusing on what we might term a traditional revenue requirement.

What we do know is that when exchanges are being sold of, rural exchanges are being sold off, the prices that the buyer is paying for them are multiples of book value, which would certainly give an indication that buyer expects not just to recover the book value of that investment, the embedded cost, but will in excess of the book value.

So, I think in point of act, if

you're going to continue to rely on embedded costs, you must make the very kind of determination that Dr. Lehman has suggested is inefficient. That is, you must make a determination as to whether or not that subsidy is required, whether or not all sources of revenue -- some of which may be below the line and non-regulated but nevertheless flow to that infrastructure -- are, in fact, not fully sufficient to recover the investment. And I don't believe there's ever been a demonstration to the contrary.

COMMISSIONER JABER: And the definition issue and whatever follows.

MR. COIT: Can I speak to that first, please?

My name is Richard Coit. With respect to the rural definition issue, and you mentioned the fact that we had taken a position on that. And in our comments, we have taken the position that -- with respect to determining distribution of support that the rural definition that's contained in the federal Act should be used. It would seem that that -- I guess you can raise an argument as to, you know, what the legal ramifications might be to try to pursue some other definition.

But the fact of the matter is that the law today defines rural telephone companies differently under the ETC designation provisions. And it would seem to us that you have to maintain some consistency with that because of the public interest standard that is there. That is there for the purposes of evaluating whether a carrier should receive federal universal service funding and through designation as an ETC.

One of the concerns that we have with respect to the way things are working today, is it appears to us that there are competitive carriers that if you looked at them in total, you know, certainly would not be receiving rural support if you look at the rural definition. They're receiving rural support simply because they're providing service in a rural area. And that accounts for -- I think we noted in our comments that it appears that that may account for about 25 percent of the support that's going out to competitive carriers. And that's a concern that we have that we do believe should be addressed.

MR. WELLER: Commissioner, there's a famous article in economics called the Disneyland Dilemma and maybe that was anticipating your question. I don't know. Let me just mention a couple facts in framing the answer to your question. First of all, a large number of -- as you know, midsized carriers have been growing a lot recently. And a lot of the lines that we're talking about here are those that they have acquired from larger carriers. So, there are already constraints on the support that they receive. So, for a lot of -- a the large portion of the ones we're talking about, this may not be that great of a change to treat them as non-rural because respectively they're capped at that level already.

There are also some safety catches already built into the system, the safety-valve system. And it probably makes sense to continue that sort of cap for extraordinary circumstances where it's really necessary to make large investments in a particular area. Having said that, though, I think if you look across the larger companies -- incidentally, my company would be affected by this. I think our estimate is it would probably cost us about $7 million per year in support to do what I've proposed. But we need to look at ways to preserve the support so it's directed to where it's really much needed.

I think if we're looking at carriers who, either because of their size have economies of scale similar to larger companies in terms of large portions of their, essentially, overhead parts of their operations or else because of the areas that they serve in terms of density loop investment and so on, aren't that different an operation than non-rural companies, then we do, I think, have to start to think about the wisdom of treating them in the same category as much smaller companies.

And as far as the definition is concerned, again, I'm not the attorney here. This could be my revenge on lawyers trying to do economics. My understanding is that the definitional differences set forth in the Act is with respect to certification of the ETCs. And the Commission is not obligated to use that as a dividing line in terms of the way funding is structured and indeed only arrived at that after several years of deliberations as a matter of convenience. So, they can depart from that if the Joint Board of commissioners finds that suits what they need to do.

MR. GARNETT: Just to follow on Mr. Weller's point, the Act in section 254 does not talk about rural carriers. It talks about consumers in rural high-cost areas. This is a point actually made back in course of the RTF proceeding by the Vermont and Maine Commissions, and the Commission noted that in the order itself in a footnote buried in the back of the item, but I do remember it.

I think the critical thing here is that whatever support mechanism we have has to target support to rural areas, not to rural carriers or to carriers based on whether they might be big or small. So, your example of Sprint in Florida is a good one but --

COMMISSIONER JABER: Smart City.

MR. GARNETT: I'm sorry?

COMMISSIONER JABER: Just for the record, it's Smart City Telcom.

MR. GARNETT: Okay. Well, the other example is Sprint has 2 million lines in Florida. That is the one I thought you were thinking of. But in any case it could be that Sprint does serve some high-cost areas or the company you were talking about does serve some high-cost areas. And whatever support mechanism we have in place should target support to those high-cost areas.

One of the problems with the current system is we have this problem of averaging. So, under the current system if you have a study area that has 2 million lines in it and there are high-cost and low-cost areas in that study area, you're not going to get support under most cases. And the same thing is true under the non-rural mechanism where you average costs at the state level.

We think ultimately the better system is to get rid of the statewide averaging and study area averaging and target support to wire centers or to a specific, small geographic region. And that, we think, is more consistent with requirement of the Act.

COMMISSIONER ABERNATHY: Why don't we go ahead and move on to Billy Jack.

CONSUMER ADVOCATE GREGG: It's hard to know where to start. There are so many issues and so many questions. But I guess we may as well start with this, I'm sure you all saw this on the cover of the USA Today yesterday, the story about universal service paid out to rural companies.

The allegations in the story and the anecdotes that were given is that there are a number of small rural companies that were earning well into the 20 percent range, paying out large dividends and large salaries to their employees, that nevertheless pulled down large amounts of federal universal service funds.

There are currently state universal service funds that take a last look after the mechanism has run before they determine whether any additional funds or support should be paid out. They look at a bottom line, whether that's earnings or a certain specified amount of revenues over the earnings. The federal universal service fund for rurals does not look at costs. And, in fact, local switching does not even -- I'm sorry, looks at cost. Local switching does not even look at cost in paying out support.

Has the time come for the federal universe service support mechanisms to take a last look, either based on total revenues produced by the loop -- and we considered unseparated loop costs -- or to look at the bottom line return in determining whether additional federal universal service funds should be paid out? And I'll just put that open to any of the panelists.

MR. WELLER: I guess we need a volunteer. I'll step forward.

I think this is sort of a fundamental question we have to ask ourselves about philosophy here before we get into specific details, because there are all sorts of ways that we can go back to more regularly approaches. I've already mentioned, you know, constructing cost models and tried to prescribe costs. We can also sort of -- we can go back and audit people trying to look for bad actors, or we can suck back into regulation, processes that are starting to step away from it.

I think the answer to your earlier question about what do we do in a broadband age is that we don't get more with regulatory, we get less from regulatory. As I said earlier, I think we need to find ways to have universal service be efficient, but we need to be clever in thinking of ways to do that that don't rely on more regulation because we probably want to decouple universal service from regulation. And the amount of support that's needed in area may be separate from the amount of regulation that's needed in an area. So, I would be very concerned about a mechanism that would require us to go back and do essentially a rate case on every company at the end of every year, even though I think that's well intentioned.

I think something that sets incentives in the structure of the payouts in the manner that we've had good results from, is incentive regulation both at the federal level and the state level in the last 15 years is a simpler, less contentious, and ultimately more productive way of going about things.

CONSUMER ADVOCATE GREGG: Dr. Selwyn?

DR. SELWYN: Thank you. You know, the proponents of embedded cost as the basis for support seem to want to have it both ways. They want to retain the trappings of a regulatory burden while not actually -- in terms of the basis for funding without actually accepting the mechanism of regulation to determine that the funding is reasonable.

What we have right now is -- and I think there's very strong evidence of this -- is that carriers in rural areas who are getting high-cost support are also able to exploit -- and I don't mean that in a pejorative sense. They're able to exploit their infrastructure to develop new revenue sources from broadband services, DSL, other things that are capable of producing revenues sufficient to defray all their costs. And in those circumstances it seems to me that it's entirely unreasonable for anyone outside of those communities to also be asked to provide subsidy.

As I mentioned, there is strong evidence that these properties are valued at well in excess of embedded costs, which means that people buying them -- smaller companies, smaller midsize companies that are buying rural exchanges are prepared to -- are willing to in effect capitalize future excess earnings by paying premium prices over the cost of support for those assets.

That in itself is evidence of the sufficiency of the existing revenues from all sources, because that's what the buyer looks to. The buyer does not limit the scope of a decision to regulated revenue. The buyer looks at all revenues. At an aggregate level, the holding companies that own a lot of exchanges that are receiving high-cost support are similarly being traded. Their equities are being traded well in excess of book values. So, their investors, their public stockholders, are making a similar kind of choices.

We don't -- in a sense -- maybe I

would be forced to agree that maybe we don't need to do general rate cases on each of these companies because the evidence is overwhelming that their revenues are sufficient without support. But if a company wants support, it seems to me it has to be asked and made to make a showing that that support is required.

MR. GARNETT: In response to your question, we don't think that, you know, the commissioners should get in the business of punishing companies for making money. But at the same time I think that we don't think it's appropriate for universal service to be one of an ETC's best profit centers.

And under the current system, under embedded cost system, and also under the forward-looking system, carriers are guaranteed a rate of return under the high-cost universal service mechanisms. And that rate of turn, by the way, was determined -- was based on the then -- the cost of capital for Bell operating companies 16 years ago, 11.25 percent.

I think that USAC does a pretty good job of paying out high-cost subsidies to the carriers that receive them. I'm guessing that they always get their check from USAC eventually. There's no risk associated with universal service. So, let's get risk-related profits out of the universal service mechanisms.

One thing that CTIA has proposed among a number of fixes to the current system is to basically reduce that 11.25 percent to a lower number that would reflects -- that basically gets that risk-related profit out of the universal service mechanisms. Ultimately, we think that profits should come from consumers, not from the universal service mechanism.

COMMISSIONER NELSON: Mr. Reynolds.

MR. REYNOLDS: Jeff Reynolds with ITTA.

Some of this rate-of-return-bashing, I'll call it, is it's a little bit misplaced. First of all, I'd like to correct the notion that there's a guaranteed return that comes out of rate-of-return regulation. Particularly in the federal rules, it's the opportunity to earn 11 and a quarter. And that just doesn't come cruising in there easily.

Also, relative to the cost recovery mechanism of high-cost universal service, while I agree with Dr. Selwyn that in evaluating acquisition companies certainly look at all revenue streams that are available. There's considerable time between when deals are struck and when those deals are consummated. Particularly for ILECs, there's a considerable process where that's vetted through both the state and the federal regulatory agencies.

So, while there's obviously -- you know, what this historic revenue streams have been as a practical matter when these companies acquire rural exchanges, oftentimes there's considerable investment, considerable risk that goes along with that. You don't get paid back instantaneously. You know, the current embedded cost, rural high-cost universal service mechanism works on a lag basis. So, you're getting a return on your unseparated loop costs, but it doesn't all come back.

And, in fact, as you lose lines to competition over time, you're undergoing considerable risk. In a way an embedded cost mechanism -- and without even the necessity for a rate case, it's self-correcting in the sense that -- to the extent that the reporting mechanisms are in place there, there's a lot of accountability, and it can be measured and monitored. And as Dennis suggested -- although you don't necessarily want to get that business -- if there are abuses and bad actors out there, there's a way to get at them right now. So, I don't -- I find a lot of the rhetoric on this unfounded.

DR. LEHMAN: This is Dale Lehman.

Returning to your pointing to the newspaper, it seems to me there's three courses of action to deal with with issues of abuse.

One of them is, as you suggest, not looking at the earnings of the company. But I share Mr. Weller's concerns that we're headed down a road of much more regulation and really full blown rate cases for every single rural company.

A second course of action is better auditing. Auditing is not perfect, but certainly can be done and more resources put into auditing can catch the, quote, bad actors.

The third course is the one that Mr. Weller suggested, and I think has a lot of appeal, which is just to have better incentives on the cost side and a price cap mechanism which essentially you have on the overall fund today, having frozen the size of it. You know, it has a lot of appeal.

The only thing I caution you is to be careful what you ask for because when you put strong cost-reducing incentives in place, that means strong cost-reducing incentives. And some of those might be in terms of not rolling out broadband as quickly because despite the ability to leverage the existing infrastructure and make broadband revenues, many companies have such low take rates on broadband currently that it is not a profitable investment. And they will think harder about making those investments in the future.

So, before you go down the road of throwing out auditing and saying what you want is stronger incentives, at least make sure that you thought through that you really want cost reduction to be first on the mind of all the companies under universal service funding.

DR. SELWYN: Lee Selwyn.

I don't think this is an issue of bad actors and good actors. Clearly, you can always find some bad actors, and that's what the USA Today article has identified.

But we have a system that does not encourage efficiency, that rewards inefficiency. And even without impugning the integrity or honesty of anybody, the fact is that when a company is confronted with an opportunity to have its costs recovered, to be made whole, irrespective of the way it runs its business, that is an absolute, guaranteed ticket to inefficient operations. And we try to address that to the larger ILECs with price cap regulation. And unless we are prepared to do similar types of monitoring as we did in the pre-price cap days under rate-of-return regulation for these smaller companies, these inefficiencies will persist. And it's not an issue of bad actors. It will persist simply because the institution encourages it.

CONSUMER ADVOCATE GREGG: My second question deals with the role of the states. Under the current universal service mechanisms of the federal government, if a rural company qualifies for support, it receives that support, irrespective of what the state does with rates or with its state universal service fund or whether it has a state universal service fund. The Tenth Circuit Court of Appeals directed the FCC and the Joint Board to develop a support system for non-rurals that contains some sort of inducements to the states to help support universal service. Indeed, the Tenth Circuit said that it had to be a joint effort of states and the federal government.

Do you believe that it would be appropriate to require states to do certain actions first in terms of rates, in terms of state-supported state universal fund and to maximize those state resources prior to calling on consumers in other states to help support their rates within their state?

And I'll ask Mr. Quoit first and then Mr. Garnett.

MR. COIT: Thank you. We definitely believe that something needs to be done along the lines of encouraging states to take a share of the universal service burden. Over the last several years we have seen in non-rural areas, I think, two or three additional ETCs designated. In the rural areas of South Dakota -- and not necessarily all of the rural areas of South Dakota, but we have at this time the incumbent has an ETC; one wireless carrier has an ETC; another wireless carrier that -- actually, two other wireless carriers have applied, and it certainly appears that the second wireless carrier that applied has a fair shot at getting ETC status.

And I look at that and it seems to me that the reason it is happening is that our state Commission has absolutely no skin in the game. They're looking at it as a way of improving wireless coverage, period. And it's made really without regard to, I think, the real facts of some of these -- the reality of the low densities in some of these areas.

Golden West Telcom cooperative is the largest cooperative in the state of South Dakota. It covers about 25,000 square miles. If you look at that and you consider that area to be a state, it would be the 41st largest state in the country. And it serves only 2.1 access lines per route mile of facility throughout that entire area on average. Does it make sense to be designating two, three, four ETCs within that area? We can talk about inefficiencies and waste so forth, but that whole issue of portability and the number of ETCs that are designated, the states have to be accountable. And I don't think today they are.

You mentioned the benchmark. It seems to me that that is a critical element going forward to making sure that, you know, there isn't some abuse. You know, should companies be getting a bunch of USF if their local service rates are 6, 7, 8, $9 a month, no. I don't believe they should, and I think there's a reason for those benchmarks. And that is to not necessarily to require companies to move their rate up to a particular level, but make sure that if they don't that the modest support they get is going to be impacted by that.

MR. GARNETT: We definitely think that states have an important role to play, and the Tenth Circuit has said they do. And in the non-rural proceeding that's certainly something you looked at. And in our comments one thing that we noted is that in many cases you have a situation where rates in rural areas are actually lower than they are often in urban areas. Sprint went into considerable detail on this issue in its comments. SBC talked about this issue a couple of proceedings ago, in the non-rural proceeding.

One idea that we talked about which ultimately didn't make it into our comments but I think is actually kind of an interesting idea is to develop an affordable nationwide rate and support a percentage of costs that are above that benchmark, use that as your benchmark. And that way you can encourage states to do more to increase rates for rural

ILECs and for ILECs generally and to get us to a situation where rural ILECS are getting more than 17, 18, 19, 20 percent of their revenues from customers and away from a situation right now where you have carriers getting 80 percent, in some cases 90 percent of their revenues from a combination of universal service and access.

COMMISSIONER NELSON: Let me pick up on something Dr. Selwyn has mentioned. And that is that no one is looking at the cost and that there is certainly no incentive to control cost under the system.

And I'd like to ask either Dr. Lehman or Mr. Reynolds. I think Mr. Weller has a proposal which responds to that point. And that is to look at the indexing of actual expenditures, looking back at the actual loop cost over a 12-month period and indexing them. Would this be a suitable way to look at controlling costs for rural telcos and should this be applied to all ETCs in the area?

Either Dr. Lehman or Mr. Reynolds.

DR. LEHMAN: This is Dale Lehman. As I was trying to indicate, I think one of the real appeals of this proposal is that it does give cost-reducing incentives. But whether or not that's what you want, I mean, we all think about the good kinds of cost-reducing incentives, which are to avoid waste and inefficiency. Some of the cost reduction might take the form of not rolling out new services well in advance of demand, which many rural carriers have done. So, I'm not entirely sure that maximizing cost reducing incentives is always a wise thing to do.

But on the face of it, I think that does address a lot of the concerns. And for all practical purposes, we are doing that today except not on a carrier level. In terms of the whole fund, it is indexed to inflation, and the fund is not allowed to grow -- you know, we re-initialize the cap, but it's still capped.

COMMISSIONER NELSON: Should this be applied to all ETCs in the area, though?

DR. LEHMAN: I'll deal with that in the second panel, because I don't believe this is the basis for the competitive ETCs that are sitting here today.

COMMISSIONER NELSON: Mr. Reynolds?

MR. REYNOLDS: I think one of the things with -- I guess I regard the indexing mechanism as unnecessary just from the standpoint that the embedded cost mechanism that's out there right now is self-correcting.

I want to circle back to something that Mr. Weller said relative to the efficiencies that come with holding companies. Most of the operating costs associated with high-cost loops exist at the operating company entity. So, when you've got multiple entities within a state, the efficiencies are not happening in these non-contiguous areas. I think the efficiencies that happen in corporate operation expense exists back at the holding company level. That flows down through the mechanism, so in that sense it's almost self-correcting.

It would probably be interesting to look and see over time how the rural companies on an embedded cost methodology have performed. I know that just from dealing with companies such as CenturyTel and AllTel that they're not even hitting the corporate operating expense limits right now. So, that cap is, to a certain extent, meaningless and those efficiencies are flowing through. So, I think that going to an indexing approach is unnecessary at this point in time.

COMMISSIONER NELSON: Joel?

MR. LUBIN: I wanted to clarify a couple points and also ask Dennis a question in terms of his indexing approach, because AT&T also put forward an indexing. And I don't know if it's the same, so I'm going to describe what we talked about and so how parties react.

But for me the dilemma here is that the incumbent rural telcos are rate-of-return regulated. And when you are rate-of-return regulated and then you have, let's say, 1300 study areas, trying to figure out either a price-cap mechanism or a forward-looking costing tool for the diversity and richness of the 1300 rural study areas, is a very complicated process, whether it's a model or whether it's a price cap. And so, right now the way in which they're regulated is rate of return.

Now, it's true that we have a cap on the high-cost fund, but that cap is only on rural telephone company incumbents and it's indexed in aggregate. The CLECs who come in, be it wireless or wired, if they're a CETC, however much money they get is above and beyond the cap, the fund.

So, my question to Dennis is what AT&T put forward was the concept of once a the CETC shows up, be it wired or wireless you, in effect, look at what the incumbent per line is getting. The incumbent going forward, if they lose a lot of lines such that their subsidy per line could skyrocket because they're rate-of-return regulated, their costs really aren't shed, but if, in my extreme, let's say they lose half their lines just to make a point. The subsidy per line could be more than doubled. And we said, that doesn't seem to be fair if the incumbent, because a CETC wins half the lines and doubles the subsidy per line, that the new entrant should get the same amount.

However, it did make sense that if a

CETC entered, be it wireless or wired, they should get the same amount on day one, but not the inflated amount if you're rate-of-return regulated and if the incumbent's losing a lot of lines. However, there was a balancing act. The balancing act is if the incumbent is going to be investing aggressively for whatever reason, moving from circuit switch to IP. Whatever the reason, if they're investing aggressively and the overall revenue requirement was growing, index the day one subsidy per line based on the overall revenue requirement growth of the incumbent.

And all that is attempting to do is create a rough-justice balancing act so that if incumbent is losing a lot of lines and they're rate-of-return regulated, the subsidy per line skyrockets, the new entrant shouldn't get the higher amount going forward. But if the incumbent is investing a lot to upgrade their infrastructure, then presumably someone else who's going to try to compete is going to also have to upgrade their infrastructure. And so that was the indexing that we put forward.

So, my question for Dennis is, is that the kind of indexing you were talking about, because when I'm listening to some of the respondents on the panel, I hear some people saying that they really can't support that concept? But my question is, if you bifurcated it the way I have just done, do people have a different view in terms of seeing it as a rough-justice solution?

MR. WELLER: Rather than go back through all of that, it might be easier for me to explain what exactly I'm proposing.

First of all, I don't think we should -- first of all if we adopt my earlier proposal of one ETC per area, then the issue of bifurcation becomes moot. Where we haven't done that, I don't think we should be bifurcating. I think we should always be the same. I don't think we should be setting up a handicapping mechanism. We shouldn't be saying to one, you're less efficient and we're going to make you a handicap. I don't think that's a good idea.

COMMISSIONER JABER: Excuse me. I'm sorry. I just wanted to let you know that the court reporter has signaled that you all need to use the microphone a little bit closer.

Sorry, Madam Chairman.

MR. WELLER: What we're proposing -- and I think this is also in answer to your question you asked earlier, Commissioner Nelson, is that unlike the current overall cap on the fund, this would apply to all ETCs in all areas, so sort of close that opening in the control mechanism.

Second, it would be specific to each area, not averaged over the entire fund. I think a funny thing about the incentive structure with the current fund is if carrier A spends money in year one that affects carrier B's draw in year two, and might create a little better alignment of interest in carrier A's decision, affecting carrier A. So, we're proposing specific indexing in each area.

And I already mentioned that there might be extraordinary circumstances that would require various escape patches or safety-valve mechanisms. And I think that is actually is a better way of dealing with the kind of service issues that Joel was talking about, because ultimately all I can do is compare to my own company's experience. We've lot of lines over the last few years, and nobody's given us a guarantee.

If you look at a lot of market estimates, many on Wall Street predict that we will have half as many lines in a few years as we had a few years ago. And our response is to invest more in our network to create more value and generate more revenue. And we're doing that without any guarantee or without any sort of bailout. I think ultimately down the line if you're giving rural carriers infrastructure grants, you want encourage them to do the same thing to get as much value out of their network as possible, not as little.

And you'd have to ask how much regulation or interference with their prices you want to step in and do, because it might interfere with that process. And, again, I don't think you want to get in it sort of at this stage on the way there, creating separate mechanisms for different carriers in different markets. I think you need a specific mechanism that pulls each carrier on a per-cost standard. It's set on their starting point. It's not based on which particular cost model we're trying to take things away from them, but saying that going forward they're going to have to manage their business on this basis.

COMMISSIONER NELSON: Real quickly, Joel, and then we'll move on to another question.

MR. LUBIN: Just to clarify, the thought process that I shared with you is really for a rate-of-return entity. What I just described is unnecessary for, let's say, an incumbent like Verizon. The reason why it's not necessary is because we're using a high-cost model. And the high-cost model is a forward-looking model, which does not create the problem.

The fundamental problem that we have is we're not using a high-cost model to independently calculate it. We're using the incumbent's embedded cost. And because of that and because we're using rate of return, that's why we see the phenomena and the potential risk exposure on wireless expansion. And the issue is is there a way to maintain no model, rate of return, and create a rough-justice balance. That was the question I was highlighting.

COMMISSIONER NELSON: I have a question for Dr. Selwyn.

Dr. Selwyn, in Mr. Reynold's testimony he refers to the dubious track record of TELRIC. Do you perceive it would be more difficult to apply a TELRIC to rural carriers having the experience of non-rural carriers, or have we learned from that experience that would benefit to applying it to rural carriers?

DR. SELWYN: The dubious experience with TELRIC is in the eye of the beholder. I don't see specifically offhand why would we necessarily not be able to construct models that would establish some indication of order of magnitude for different costs for rural carriers given the parameters of their circumstances. This is not -- quite frankly, it's not rocket science.

These companies, while they each

confront unique terrain and density issues, they are still, at bottom, using the same technology, the same types of facilities, the same engineering network architecture. And I don't really believe that it is not possible to develop -- to incorporate them into a modeling approach. And what that will do is to de-link support from the company's own self-serving cost investment and operations decisions. It will also de-link the funding mechanism from cost allocations, which -- I was describing to somebody yesterday -- as 99 part art and 1 part science. And I think I may be overly exaggerating the amount of science.

We need to come up with mechanisms that are out of the hands of the individual companies and that provide a robust and consistent basis for funding irrespective of how these companies are individually managed. I don't see in particular reason why that cannot be done on a forward-looking basis.

COMMISSIONER ABERNATHY: Thank you.

DR. LEHMAN: Could I add something?

COMMISSIONER ABERNATHY: Not right

now, but you'll get a chance. I'm sorry. I really want to make sure everybody gets to ask questions.

In fact, my question is kind of a follow-up on what Commissioner Nelson started with. And that is, I think -- Mr. Lubin, Mr. Reynolds, Dr. Lehman, the impression that I got is you're basically saying -- without regard to what we do with ETC -- that we just keep the status quo. There is really no changes that need to be or should be made today. But most economists would argue that we need to at least get a grip on how we can create incentives for efficiency.

And so my question to all of you is, is there anything that can be done today, or are you saying, let's just -- no change?

DR. LEHMAN: This is Dale Lehman.

I do think that the idea of the price cap has some merit if you want to enhance cost-reducing incentives. As I thought about it a little more, I think my biggest concern is with these very small carriers, some of them have -- their plant is in a different shape. And sometimes carriers change, and all of a sudden they need invest more where historically they may not upgraded facilities very much.

And you can handle this through special cases, but I guess I just want to throw out another alternative, which is maybe we cap the fund at the state level. Each state gets indexed by inflation the amount of high-cost funding it previously got in the last 12 months. And then let the states work out internally how that filters down to the various companies they have within the state, which I think on the face of it has the appeal to me in terms of having the state make some closer-to-the-ground decisions about where the money is best used. So, it provides -- I think it provides a lot more discipline in the marketplace without what I would call handcuffing individual carriers in a way that might be very difficult for a small carrier.

COMMISSIONER ABERNATHY: Mr. Lubin.

MR. LUBIN: It's a very tough, tough question. My bottom line is the system is so fundamentally broken, whether it's USF methodology we're talking about now, whether it's USF contribution, whether intercarrier compensation. It's fundamentally broken. And from my point of view, the most important thing in terms of prioritization of resources is to try to figure out the intercarrier compensation and the contribution methodology.

Once you've solved that -- and, in fact, in some of the solutions, in particular the ICF, has included various components that addresses these issues, in particular the one that I've already described that says the incumbent rate-of-return carrier should have a different subsidy per line than an ETC if the subsidy per line is rising because of the incumbent losing lines. And the CETC shouldn't be given that. And that should be clear that that's not going to happen. So, you create inefficient entry.

Thank you.

COMMISSIONER ABERNATHY: Mr. Reynolds.

MR. REYNOLDS: Thank you, Commissioner Abernathy.

I think one of the presumptions here that efficiencies can only be created through regulation is a little bit off the mark. Generally speaking, I think that there are a lot of reasons why the companies want to operate efficiently, certainly just not to gain a system of universal service support.

One of the things -- and this kind of goes to Dr. Lehman said that you don't want to create an incentive that removes an incentive to invest in rural America. And aside from, you know, kind of the strict language of what we think Congress intended with the Act, which is to have a specific, sufficient, and predictable universal service fund, there's also this concept of uncertainty that comes along with the idea of continually changing up the regulatory scheme so that as you go to the capital markets, for instance, to draw down money so that you can invest in rural markets for rural consumers, that that creates a lot of the uncertainty.

So, I think when Joel describes sequencing some of these regulatory events, it's -- I wouldn't characterize it as business as usual. I think that what ITTA is saying in this instance is don't change the current system until we get some of these other items sequenced properly. And they all need to be taken in kind of the wholistic sense. And we're not interested in operating in an inefficient fashion at all.

Thank you.

COMMISSIONER ABERNATHY: And then --

MR. COIT: Excuse me. May I just make a brief comment?

COMMISSIONER ABERNATHY: Sure.

MR. COIT: I would like to just -- I think this needs to be said. And with respect to forward-looking cost models or any sort of price-capping mechanism -- Mr. Lehman commented on this a little bit -- we're talking about a smaller company. I think Mr. Lubin indicated earlier and made the suggestion that, you know, Verizon loses lines and they deal with it.

A rural carrier losing lines obviously because of their limiting economies is in a much more difficult position in terms of dealing with. In addition to that, you know, with respect to the forward-looking cost model, you know, one of the reasons that the

RTF after their studies recommended that it's not appropriate or suitable for rural companies was because of the disproportionate impact on rural carriers as a result of errors in the model.

I think the disproportionate impact that we're talking about if you look at that -- looking at some sort of price-capping mechanism is that when a rural carrier has to replace a switch, the percentage of cost that that makes up on the entire rural cost carrier's of that year is much than for larger carriers. They're not in a position to deal as easily with substantial investments that are needed in their networks because of whatever technology that may be coming down the road that they really feel their customers need in order to get the services that they deserve.

So, you know, I think that is a caution that, you know, don't forget about the economies that are faced. And they're much different and the impacts are much different. And I'm not sure that price capping mechanisms just as forward-looking mechanisms can deal with that in a very easy way.

Thank you.

COMMISSIONER ABERNATHY: Well, that sort of leads to my next question, which was, in the old technology world, I think, yes, that was true because all you were delivering, the only revenue source you had from the loop to home was voice. And there was a certain amount that we believed that consumers would pay for voice and that's where we were.

But as we're moving into a world where the pipe to the home can deliver many other valuable services so you've got multiple revenues streams from that source, how does that or how can we factor that in when we look at what, if any, changes should be made? Because it really changes the way that you recover your cost for your plant, because all of a sudden the plant can deliver more value than it used to deliver in the old world.

Mr. Lubin, Mr. Coit, and then Mr. Weller.

MR. LUBIN: I want to respond directly, but I just want to make a highlight on Mr. Coit's point.

And my highlight to him is the very reason that he is articulating his last point is the reason why I was bifurcating the difference between an incumbent like Verizon versus a rate-of-return entity, literally having two different approaches. With regard to the broadband, for me, that's a wonderful question in the following sense: it comes back to the issue -- and I'm going to focus on rate-of-return rural companies -- if you're rate-of-return today and you are trying to make a decision of do I market -- not do I deploy broadband investment because if you're rate of return, I believe you have every economic incentive to deploy investment. Do you have the incentive to market the broadband?

And when you're talking about 1300 companies, everybody is all over the place. So, I'm just making a general observation. And the general observation is, you made the point, well-founded, that says there's going to be new revenue opportunities. And the point that I want to make, though, is if we don't fix intercarrier compensation, then the average intrastate access revenue is five cents per minute to originate and terminate the rate, and that goes from anywhere from, say, two cents to 35 cents -- I just quoted you the average of five -- if they sell that broadband pipe and then somebody puts an application called VoIP, voice over the Internet, over that, they're going to cannibalize. And if that customer is a high-toll generator in a high-toll traffic, well, they're going to cannibalize. So, the point is unless we fix intercarrier compensation, we don't have the right incentive. In fact, we have a disincentive for the incumbent to aggressively market that product to the rural customer.

COMMISSIONER ABERNATHY: And, yes, I hear you on and -- yes. We know that. And, unfortunately, this Joint Board, we don't -- that's not our area or our proceeding. But I think at the FCC there is a real recognition that intercarrier comp distorts all kinds of market behaviors and destroys business plans. And the distortions flow over into rural areas as well as the non-rural areas. So, I agree we've got to deal with that. And, you know, at the FCC we're looking forward to putting out a proceeding seeking comment on the most recent proposals. And we really appreciate all the work that's been done on it.

So, I think what we're trying to do here today is say, in addition to that, what else can we do. But thanks for pulling them together.

I can't remember what three people I called on, now. I think Mr. Weller and I believe Mr. Coit.

MR. COIT: And I'll be brief. Just with respect to the question of whether, you know, given the increased value of -- what the effect of that might be, I would agree that certainly there are additional services that are provided over those facilities which certainly offers some opportunity.

At the same time, though -- I think this is in part what Mr. Lubin was getting to -- we're dealing with the intercarrier comp issues and rural carriers on average -- and I don't know exactly what the percentage is in South Dakota today, but we all know that across the country in terms of total revenue recovery, looking at rural carriers, much of it is wrapped up in assets in USF.

And to the extent that you may gain, you know, some additional revenue from some additional services, maybe that's going to just be necessary to replace what we've lost. But, you know, certainly there's a lot of pressures on the other revenues. So, that has to be taken into account.

COMMISSIONER ABERNATHY: Mr. Weller, you'll have the final word.

MR. WELLER: Thank you, Chairman Abernathy.

I think, first of all, as far as adding value is concerned, that's what you want the carriers to do. You want to structure the system so that you can give them incentives to do that. Their circumstances are very different from ours, of course, but we want that same incentive to add value to replace what you're losing in your traditional business.

And I think that decoupling the support from the variations that we've had, the calculations that we've done in the past, is part of that. In other words, you want the support to reflect some sort format that they can get but they have to work with in order to go forward.

Interestingly, I've just heard some interesting programs that the British have adopted to address this concern that Mr. Lehman raised about putting broadband in rural areas and not having anybody sign up. That's a little outside of the scope of the discussion here. I'd be happy to talk to you about it off line.

But the final observation is simply that market structure is an outcome in terms of relatives sizes of firms and how they're organized. And I think that rather than try to design the system to preserve the current market structure, what we have to do is put incentives in place and then let the firms respond to those incentives possibly by choosing different market structures. In other words, if one of the concerns about the incentive is to scheme, it's that it becomes harder and harder for carriers the smaller and smaller they get and the less averaging you have. This may create incentives for carriers to restructure themselves so as to better position themselves to deal with these market realities going forward.

COMMISSIONER ABERNATHY: Commissioner Dunleavy.

COMMISSIONER DUNLEAVY: Thank you, Madam Chairman.

In honor of Bob Rowe, I was going to try to formulate a really complex, multi --

(Laughter.)

COMMISSIONER DUNLEAVY: My colleagues have asked all the questions and the panelists have answered them, so I've got to get back to basics here. The basic question posed by this panel was, should rural carrier support be based on embedded or forward-looking costs? Not surprisingly, implicit in all of the answers there seems to be significant differences of opinion on whether the purpose of that support should be to maintain the financial health of an incumbent LEC or to mitigate the higher cost.

Let me ask you to assume for a

moment -- and that's probably dangerous -- that the purpose of the high-cost support is to mitigate cost differences among different areas, rather than the different cost among different carriers. Given that assumption, our task would be to determine if cost variations exist among various areas of the country. Now, Mr. Coit, perhaps can do a better -- you might help me out.

Population density is or appears to be a significant driver of cost disparities among various areas of the country. Are there any other characteristics, perhaps topographical, climatic, that contribute significantly to such cost differentials?

MR. COIT: Yes. I think there are a lot of them. I think that that's primarily a problem in trying to come up with a forward-looking mechanism that would be accurate enough that you don't have some significant errors that cause some impacts that you don't want to see. I think low density, though, is a huge driver.

You know, in a lot of cases, I think, it boils down to distance. You know, if you just look at the areas, if you only have 2.1 subscribers per route mile, it's pretty obvious that you're going to spend a lot more to reach those subscribers. And it's the function, I think of a lot of things. And I know I'm not giving you much of an answer here, but do I think it's a multiple number of factors. You know, size of the company certainly has a lot to do with it as well in terms of number of people that you have -- the number of people that you have working for the company and the number of people that you're serving.

COMMISSIONER DUNLEAVY: That being the case, would it make any sense to identify a half dozen or dozen types of service areas, if you will, reflecting density and other significant cost factors and then estimate average costs of serving each type of that area in an efficient manner?

MR. COIT: I personally don't believe that you should necessarily look at just the area served. I really do believe that larger companies have some economies and somebody to manage it that smaller companies do not have.

In a competitive environment, it's certainly harder to average and price the way you want to price, but I don't think any of us could say there isn't some averaging that occurs.

And I think that, you know, if you're looking at areas served rather than the companies, I think you're assuming that there aren't any of those efficiencies. And I don't think that's appropriate. I think you need to look at areas served in part, but I think more than anything it should be tied to the companies directly, and we define the companies appropriately based on the areas they serve.

COMMISSIONER DUNLEAVY: I wonder, Dr. Lehman, if perhaps -- and maybe this is further expanding on what Commissioner Abernathy asked. Could we invent a similar means of estimating costs and perhaps based on actual costs, the best-in-class or something like that?

DR. LEHMAN: Two different answers, one to the first question. I'm in agreement with Dr. Selwyn here. I actually think that order of magnitude forward-looking estimates probably can be accurately obtained. My point would be that order of magnitude is not good enough for small carriers. It's the difference between making far too much money, far too little money, or possibly the right amount.

And to Mr. Weller's point, I don't really think you want to pre-guess the market structure and put small companies out of business because they can't live with the degree of accuracy that you're able to produce in the forward-looking cost model.

Now, having said that, to the last question that you just asked, are there other ways to come at what a forward-looking cost might be. You know, I've done some simulations of how forward-looking costs and embedded costs differ across a number of characteristics. And you can produce fairly confident predictions about how different they might be, and it's on the order of 10 percent or less for loop costs.

But having done that, in the end, what do you come up with? You come up with something that's only validated by comparison to embedded costs anyways. It sounds like a lot of work to still be -- you have to validate the results of this to know that you have reasonable cost estimates. And there's nothing else to look at other than embedded costs. So, in the end embedded cost have to be the guide to whether you came up with a reasonable cost model. You have a thousand inputs. And even if you 900 of them are accurate, you don't know if you have a reasonable output of that model unless you compare it to something real. And unfortunately the only real data we have to compare it to is embedded cost.

COMMISSIONER DUNLEAVY: That's a little different than Dr. Selwyn.

DR. SELWYN: Just one quick comment. Dr. Lehman mentioned the model that he developed which compares embedded and forward-looking costs. I have looked at his paper and reviewed his work. And basically that analysis starts with the same set of inputs. So, in other words, if the costs -- if the basic investments numbers are wrong to begin with, then the relationship is identified while -- while, you know, interesting at an academic level, it doesn't really teach anything about what happens if you apply an efficient forward-looking cost model one the hand versus just simply taking the books -- the costs on the company's books as embedded costs as a given. We have no information right now as to what that relationship is.

We need to start -- even an indexing mechanism, for example, simply preserves -- unless it takes a fresh look at what the costs ought to be, then it's simply preserving whatever inefficiencies -- locking in whatever inefficiencies may already by present.

When the Commission -- when the FCC and the state commissions initially adopted price cap regulation for the larger LECs, what they did in virtually every case was to conduct a full-blown general rate case to establish a going-in rate level. And then they indexed from that. They didn't simply take whatever the pre-existing rate level happened to be and go forward into a price cap world.

And so, if an indexing mechanism -- which might, in fact, have some merit going forward at least on a transitional basis until we get to forward-looking costs. If that were to be adopted, we would still need to validate the going-in cost levels as the Commission and the state commissions did when we went to price caps.

MR. GARNETT: Just getting back to the original question, I think we would agree that in rural areas you're going to have to deal with -- especially for small carriers, you're going to have to deal with the number of other inputs. The Alaska Commission in their comments talks about a long list of inputs the Commission could consider. We're realistic that it's going to take a while to put smaller carriers on a forward-looking system, and that that system needs to account for those differences.

But the fact is that 75 percent of the 1300 study areas that Mr. Lubin has talked about are 65 percent of the rural telephone company access lines. And those are all carriers with over 50,000 lines in a study area. Those aren't the companies that we're talking about when we're talking about some of the real problems with the forward-looking mechanism that we have right now. And, you know, we think that it's -- it makes sense to move those bigger companies. I think Verizon said it should be if you have over 100,000 access lines in the state. In our comments we say 50,000. You know, we can split the difference, that's fine with us.

But the point is that for some of these bigger rural telephone companies, they're looking a lot more like non-rural telephone companies that have been under a forward-looking mechanism for several years now. And in many cases they're much bigger than some of the non-rural carriers that are on the forward-looking mechanism.

I think it was either Sprint or Verizon in their comments that noted that Roseville in California has just over 100,000 access lines. They've been on a forward-looking mechanism, and I think they're still in business. They've haven't declared bankruptcy. Things are going okay. And so, all of these predictions of sort of dire consequences of going to a forward-looking mechanism for -- especially for the bigger rural carriers, I think are a little bit of, you know, seriously conclusory statements.

One of the other things I've also heard from a number of people here is that we shouldn't do it because it's difficult. I see in a lot of the comments it's complex, it's difficult. That shouldn't be a reason for not picking the right outcome, the right mechanism. And we think there are a lot of smart people in this room and together we could probably come up with pretty good forward-looking mechanism that accounts for all the differences that we've talked about.

COMMISSIONER DUNLEAVY: Mr. Reynolds, briefly because I've overdone my time.

MR. REYNOLDS: I'll be brief. Responding to Mr. Garnett, first of all, one of the things -- absolute line size has never been an attribute at all to whether somebody is rural, whether they have high cost, low cost, or whatever. You can have poor study areas and we have member companies in a states like Montana, the large, square states, noncontiguous operating areas. Line size has nothing at all to do with the operating characteristics of those companies. It's not captured in the cost models.

And I'd also go back and just -- there are a lot of smart people in this room. There are a lot of smart people associated with the Rural Task Force. And when you go back and you look at the effort that they did in there working paper number four to validate how the FCC synthesis model would treat rural companies, you find a dislocation of about $1.1 billion in loss of support to the rural companies, which included holding companies that have rural companies and stand alone rural companies.

Thank you.

COMMISSIONER MARTIN: Mr. Weller, I saw in your testimony and was intrigued about your discussion about a presumption of one ETC in each area. And I was wondering if you could give us insight into how and who would chose what the one ETC would be in your proposal.

MR. WELLER: That's an interesting question. You keep coming back to who gets the money, don't you? Frankly, I think in the near term there may be a strong presumption that it would the incumbent because of the cost of dislocation to consider. I think down the road if you're talking about something completely different, thinking beyond the near term, I'd say infrastructure grants.

I just sat through a couple days of a conference at the OECD looking at efforts to support rural broadband networks throughout the world. And almost without exception there are upfront grants and almost without exception they're awarded on an itinerant basis, option basis.

So, I think in the near term if we're talking about who gets the existing regulation, who gets the existing support, as you know, I have made some proposals along those lines in the past. But I'm not sure they're really applicable today when we're trying to change the framework.

So, I think these sort of mechanical changes that I've proposed here today are more reasonable things to deal with to do in the near term. Again, it may seem unfair, but I think in the near term given dislocation costs it's not unreasonable, excepting unusual circumstances to give a strong preference to the incumbent. But I think as we go forward beyond that, let's say, for five years from now, that we'll be freer to think of different solutions, and they would become maybe part of the answer.

COMMISSIONER MARTIN: I do know you've laid out some other proposals that we have some interest in as well. But this presumption issue, that's one of the five things that you think should be done in the short run, right?

MR. WELLER: Yes.

COMMISSIONER MARTIN: The other question I had, Mr. Coit, I certainly agree with many of the concerns you expressed about forward-looking costs, some of your concerns about the wireless and other ETCs' ability to obtain support on the basis of the ILEC's costs without having necessarily incurring some of those costs themselves or providing the same kind of service.

But I am concerned about one of the things you raise in your testimony and talk about the expansion of the base of universal service contributors to ensure everyone contributes on an equitable basis. And you talk about wanting to have facility and non-facility-based providers of Internet service, all IP-enabled service providers, all cable providers, wireless and satellite providers, and other providers all contributing into the universal service fund.

I was wondering if you would assume then that all of those same providers would be able to take out of the universal service fund as well. And if they wouldn't, why is it an equitable basis, which is what keep using as your phrasing, for these providers to pay into a fund that they are not able to take out of?

MR. COIT: I guess just generally -- and this goes back to, I think -- at least ties into some of my opening comments. Whatever mechanism -- whatever the mechanism is, you know, as a result of this process and in the future, you know, it really seems to me that it's got to be tied to those that are investing in the network. And not all providers do that. The other thing --

COMMISSIONER MARTIN: But then I just do want to understand. Then what you would say, though, is any provider that does should be able to take out; is that right?

MR. COIT: Not necessarily.

COMMISSIONER MARTIN: Not necessarily any -- not necessarily?

MR. COIT: And that's because if we look at the current situation, we've got a situation today where there are carriers that are getting money out of the universal service fund that have stated very clearly that they don't believe that they have carrier-of-last-resort responsibilities. And if you look at cost drivers for rural carriers, in a lot of cases it's those customers that are so remote that they they're the ones that to some -- to a significant degree drive high cost. And if there isn't a sincere commitment to serve throughout the area, I just don't believe the carrier should get any money.

And I've sat in two ETC hearings and that question has been asked. And, you know, does the CETC carrier have carrier-of-last-resort obligations, and the answer has been the same both times: no. And I don't agree with that. I think that there's distinguishing -- you know, I think you have to look at who's providing the facilities and who's meeting the obligations. And I also think you have to look at the area and really ask yourself, you know, is this the sort of area where it makes sense to be funding multiple carriers regardless of who that carrier might be.

MR. GARNETT: If I could actually respond to both of your questions in one answer, and this is sort of -- kind of a five -- sort of the five years out sort of time frame that Mr. Weller was talking about, that type of a proposal. You know, once a wireline or wireless carrier or whomever satisfies the structural obligations for getting an ETC designation, whether it's state or the FCC, ultimately the true arbiter of who should get the support should be the customer.

And for that reason, the Commission really should think about a long-term solution as direct consumer subsidy where you basically have a situation wherein you determine, is this a high-cost area. It's a narrowly defined area. You determine, you know, what the most efficient technology is for that area. You figure out how much support you have available for each customer in that area, and let the customer decide who they spend their dollar on.

And that way you deal with both of the issues you raised. You deal with who gets to get the money out. It should be anybody as long as the customer wants that carrier to be their provider. And you deal with the issue of, you know, whether you should limit support to one carrier in an area. If the customer chooses a wireless carrier or wireline carrier, that choice should be respected and that's how the dollar should be spent.

COMMISSIONER ABERNATHY: Thank you very much, Commissioner Martin.

Thanks to our panelists. What I think we will do now is we will take a ten-minute break before we start with panel two. I do want to thank everyone, and I know some of you are coming back for panel two. This was very, very informative and we appreciate you traveling here.

(Whereupon, a break was taken.)

* * *

COMMISSIONER ABERNATHY: Thanks again to our panelists. We really appreciate you coming all this way. We don't want to waste your time, so I think we'll start right away with Scott Bergs with Midwest. Again, a three-minute presentation, if you could, so we can leave plenty of time for Q and A.

MR. BERGS: Thank you. Again, I'm Scott Bergs with Midwest Wireless. And first of all, I want to say thank you for the opportunity to address these really important issues. In this proceeding the Joint Board and the FCC will make some decisions that will dramatically impact customers' options for communications services in the high-cost areas of the United States and the overall cost of communication services throughout the United States.

The Joint Board and the FCC will be guided and informed by representatives of small ILECs, from medium-sized ILECs, from wireless carriers like Midwest Wireless, and many, many others. But in taking into consideration all of these important views, perhaps the greatest challenge to each of you is to distinguish between how your choices will impact Midwest Wireless, CenturyTel, small independents, or AT&T, and instead focus on how your choices will impact the people who are living and working in rural, high-cost areas in purchasing communications anywhere within the United States.

I know the dramatic disparity between wireless consumer contributions to the fund, approximately 22 percent, and the small amount of consumer-received benefit from the fund -- the small amount of wireless-consumer-received benefit, about 3 percent. I'd point out and highlight that point, the customer contribution and receipt, notwithstanding my own reference in my written comments to the provider contributions. They really are not. That's a misnomer. They are passed along to the consumer, and I think it's important to highlight that fact.

And, of course, finally, the benefits derived, if the funds are appropriately used or inappropriately used and efficiently used, are consumer benefits. And if they are lost, it's the consumer who loses those benefits. Rather than focusing a lot on the actual economic disparities, I'd like to focus my comments briefly on how those consumers will be impacted under the various changes that are proposed here today.

The impetus for U.S. commercial dominance throughout the world is really our consumers' insatiable thirst for innovation and additional value. They continually drive providers like Midwest Wireless and everyone represented in this panel to be more creative and efficient in how they provide services. By making changes in this proceeding, we have to avoid taking away that customer's power to force us to be more innovative and more efficient.

As Congress determined in the '96 Act, customers in rural high-cost areas deserve the same types of services and same choices of services as those folks living in urban areas, and at prices that are comparable to their urban counterparts. While USF reform is needed now to ensure the long-term realization of these goals, we must be mindful that recently great strides have been made towards those acts.

For example, since our designation as an eligible telcommunication carrier in Minnesota, Iowa, and Wisconsin, Midwest Wireless has expanded it's coverage through additional power facilities and other facilities. That has provided health and safety benefits in emergency situations -- giving consumers the ability to dial 911 in areas where they simply could not do that before -- and for emergency responders who are responding to those calls, to be able to communicate, to learn facts during the sometimes sizable drives or transportation periods that don't exist at least to the same extent in urban areas as they're trying to get to that emergency situation.

So, the residual benefits that Midwest Wireless has been able to provide consumers in those rural markets that we serve is the provision of broadband. We do that through a couple of different networks that get an ancillary benefit from the funds and the facilities that are developed through those funds. We have a 1xRTT network, which will be evolving to an 1xEV-DO network; true, high-speed broadband access with mobility; and also operate an 802.11 network. The efficiencies that are gained are that we can share facilities with our standard voice provision service facilities. And also, we can share personnel, our engineers and our service technicians.

In essence, between Midwest Wireless and the other carriers competing in our markets, we are giving the customers choices for service, service provider, customer service, and other incremental value that the customers demand. These are the benefits that were envisioned by Congress to be derived from a dynamic and competitive marketplace, and it is important that we keep those incentives in place.

So, what do we need to do? Just a couple of quick points. First, I want to point out that there is growth in the fund, and we need to be careful to not let the fund get out of control. But there is an inherent cap, at least on the CETC side, in the fund itself. While certainly in the short term, because we made some accommodations for the ILECs back in the RTF order, there is going to be growth in the fund as CETCs enter the market.

In the long term as customers continue to fill out the number of connections that they're going to acquire, they're not going to have six, seven, eight connections. So, the unlimited and ever-expanding growth of the fund is simply not a reality. We must preserve the equality in support to preserve those motivations to keep carriers entering, competitive carriers entering into these markets, and to make sure that the carriers there are, in fact, being as efficient as they possibly can be. We are starting to see that by some of the rural ILECs in our service territory. We're seeing the handwriting on the wall, and anticipating changes, and are therefore starting to find efficiencies that they previously claimed simply could not be achieved, through shared switching facilities and other common service components.

Making these incremental reforms can

ensure that the carriers are motivated to passionately fight for those customers, ultimately reducing the carrier's reliance on government-provided subsidies which are furnished at the expense of the customers themselves. Specifically, in the short term, we can mandate disaggregation, targeting high-cost support to the highest cost areas of a study area. We can move toward forward-looking costs. We can stop system gaming of large ILECs acting as small ILECs, or identifying themselves as small ILECs. And we can eventually move towards portability of support as mandated by the Act.

Taking these steps now will ensure the customers have a right to an ever increasing expectation of value even in these rural areas. Thank you.

COMMISSIONER ABERNATHY: Thank you very much.

And now we'll turn to David Cole from CenturyTel.

MR. COLE: Thank you. Good afternoon. My name is David Cole. I'm the Senior Vice President of Operations Support for CenturyTel. I'm testifying today on behalf of the Independent Telephone and Telcommunications Alliance. ITTA is an organization of midsize telephone companies serving thousands of rural communities across the nation. ITTA appreciates this opportunity to testify at this hearing. Through this testimony, ITTA urges you to recommend that CETCs receive universal service support based on their own costs as opposed to the costs of the carrier-of-last-resort. ITTA also hopes you will recommend that the FCC modify its safety-valve rules so as not penalize carriers that make investments in the first year after acquiring a rural exchange.

CETCs should have to justify their receipt of support based on their own costs. The costs of the incumbent simply aren't relevant. As carriers-of-last-resort throughout the communities that they serve, rural ILECs have a fundamentally different role. Carriers-of-last-resort must serve every single customer that requests service. CETCs do not. Carriers-of-last-resort must comply with strict service quality and outage reporting requirements to ensure that the communities they serve are receiving high-quality telcommunications services. CETCs do not. Perhaps most important, carriers-of-last-resort open their books up to regulators and have to prove that their costs justify the level of universal service support. CETCs do not.

Just like the ILECs, CETCs should have to prove that their costs justify receipt of support at the level they request. Today, the FCC oversees a system that hands out hundreds of millions of dollars to CETCs without considering how they perform, what their costs may or may not be, or how accurate their reporting of customer lists may be. Indeed, CETC funding is growing far faster than the funding for rural ILECs. From 2002 to 2005, rural ILEC high-cost loop funding is projected to grow approximately $22 million while CETC funding is projected to grow five times that amount, or $110 million dollars. Many rural ILECs are actually experiencing declines in USF funding today in 2004, and are projected to experience even larger declines in support in 2005. Considering the fact that ILEC funding is already capped, the best way that the FCC could control fund growth would be to simply require CETCs to justify their receipt of these funds.

The Joint Board should also recommend changes to the method of calculating the support for acquired rural exchanges. Today's rule creates disincentives to investment in these acquired exchanges. When carriers acquire rural exchanges, the telcommunications plant in these exchanges typically it's neglected and requires immediate investment to meet minimal service standards, let alone to allow provision of advanced telcommunications capabilities. The current safety valve rules actually provide an incentive for carriers to delay by a year or more expenditures that would improve service for these rural customers. If the FCC wishes to encourage carriers to make needed repairs and improvements to these exchanges, the FCC rules should be changed.

To alleviate these problems, ITTA proposes that acquiring carriers be eligible for support immediately following the acquisition of the exchanges, and that the FCC should measure the baseline cost-per-loop in an acquired exchange on the cost at the time of acquisition in order to most accurately show the increased investment.

In closing, ITTA reiterates that the continued disbursement of universal service funds to CETCs as a factor of carriers-of-last-resort costs and a billing address customer list is inappropriate and should be discontinued. CETCs should receive universal service support based on their own costs. It is the only means of providing accountability needed to ensure that universal service funds are efficiently used to accomplish the purposes of the Act.

Thank you.

COMMISSIONER ABERNATHY: Thank you, Mr. Cole.

Now, we'll hear from Mr. Gene Johnson, who is with Fairpoint Communications.

MR. JOHNSON: Thank you, Commissioner Abernathy. You may have remembered that last time I appeared before the en banc hearing and you had a clock in front of us. So, therefore I have written my statement out to make sure I don't go over three minutes.

I'm Gene Johnson, Chairman and CEO of Fairpoint Communications, and we're a holding company for rural ILECs operating in 16 states. Fairpoint's average study area has just 8,500 access lines, and many of these areas are very costly to serve. Without the cost recovery Fairpoint obtains through universal service support, we would literally be unable to provide these customers with affordable, high-quality service. This morning -- or this afternoon, I'm here on behalf of OPASTCO and its 560 rural telephone company members, many of which face operating challenges similar to ours.

You may recall that last year in Denver I participated on a panel concerning the very same subject we're here to discuss, the basis of support for competitive ETCs. It seems like it's been a lifetime. Over the past six quarters since I was last before you, the projected support for CETCs in rural service areas has increased by something like

$60 million. It represents 80 percent of the total growth in the rural high-cost program over that same two-year-time period. It's clear that the support going to CETCs is driving the rapid growth of the high-cost program and placing its future viability at great risk.

OPASTCO continues to believe that the best way to address this problem is to base support for CETCs in rural areas on their own embedded costs. This would introduce the same rationality and accountability into the system for these carriers that already exists in the mechanisms for rural ILECs. Moreover, it would help to sustain the high-cost program in a way that provides every ETC with sufficient support and continues to achieve the universal service objectives of the '96 Act.

OPASTCO recommends that the joint board or FCC hold industry workshops to develop charts of accounts for CETCs in each industry segment that will be used for cost reporting purposes. Although the types of costs reported by wireless ETCs will obviously differ from those reported by LECs, there should still be cost reporting parity between the ILECs and the CETCs.

During the period of time when accounting rules are being developed, we recommend the adoption of the interim wireless safe harbor plan that was filed by OPASTCO, RICA, and the RTG in the portability proceeding. Under that plan, wireless CETCs would receive a safe harbor percentage of the rural ILEC's per-line support with the specific percentage based on the size of the wireless carrier. Again, this plan is intended strictly as an interim measure that would sunset after the FCC adopted cost-reporting rules for CETCs.

In closing, the current portability rules have placed the sustainability of the high-cost program in serious jeopardy and change should not be delayed any longer. It seems almost too obvious to say, but the high-cost program should only provide support to carriers that can actually demonstrate that they have high costs. The system needs to be accountable to the ratepayers nationwide, the consumers, who ultimately fund it.

Thank you for inviting me to participate in the hearing today. I'd be happy to answer any questions you may have.

COMMISSIONER ABERNATHY: Thank you much, Mr. Johnson.

And now we'll hear from Denise Parrish who is with the Wyoming Office of Consumer Advocate.

Thank you, Ms. Parrish.

MS. PARRISH: Thank you. I appreciate the opportunity to be here, not only on behalf of Wyoming Office of Consumer Advocate, but also as a representative of NASUCA.

I'd like to begin as I did in my written statement by reminding you of the overarching principals that you need to balance. And while I know that you know these principals, they're not always discussed in the -- to the extent that I think that the balance requires.

For instance, there's been a lot of talk about the sustainability of the fund, but there has been very little mention about affordability. And we think that affordability is one of the key items that should override your decision making and be part of the balance here, and it doesn't get discussed to the same degree that many of the other principles in 254 get discussed.

Similarly, access to quality services does not get the same amount of discussion that access to the fund gets. There was on the first panel discussion about who should be able to access the fund, but without the reminder that the whole purpose of accessing the fund is to maintain access throughout the nation. We have a wonderful, ubiquitous quality network in America, and the whole purpose of the fund is to maintain that, not to develop competitors, not to develop competition, but to, in spite of or in conjunction with competition, to maintain the network that we have. So, we hope that you'll keep that in mind.

Similarly, the comparability issue, we remind you that that ought to be one of the key items that goes to the end test. Whatever decision that you make as a result of this hearing and many other hearings and discussions that you'll have, it ought to be the final test of whether your decision is the right one should be the comparability of rates. Even if that means that you do something similar to what you did for the non-rurals, which was, if all else fails, a state can come in and ask for supplemental funding just to show that the comparability test is being met.

So, the NASUCA comments in this proceeding go to trying to balance all of those issues as well as trying to rationalize the fund. We understand that there's a sustainability problem, and we understand that there's a -- are competitive issues. We're not against competition. We're not trying to create discrimination for or against the competitors, but we believe that the fund needs to be rationalized.

And in that regard, relative to the two issues that I've been asked to speak to, the specific comments suggest that competitive ETCs should have support based on their own costs but capped at the level of support provided to the incumbents. We -- I won't go into it now. You have the written statements as to why we believe that it's both a fair competitive method as well as a nondiscriminatory method. We also believe that this is the way to remind ourselves that the incumbents do have carrier-of-last-resort responsibilities at this point, responsibilities that have not been picked up by many of the CETCs.

As to the second issue, the issue of dealing with bought and purchased exchanges, we have not taken a formal position at this point. We expect to do so in our reply comments. But again, the overarching concern should be to not provide incentives to make purchases, but at the same time to recognize that the buyers have done some marvelous things in rural areas once those exchanges have been purchased.

And with that, I would look forward to your questions.

COMMISSIONER ABERNATHY: Thank you very much, Ms. Parrish.

And now we will turn to Dr. Lehman from Alaska Pacific University.

DR. LEHMAN: Thank you. We hear a lot of the phrase, competitive neutrality, invoked as reasons why we need the equal support rule. And there is nothing in economic theory. You won't find the phrase competitive neutrality. What you will find, the closest concept is the idea of discrimination and nondiscrimination. And discrimination takes place when equals are treated unequally or whenever unequals are treated equally. And that last phrase is what I think applies here.

Wireless and wireline technologies are just different. They're different in a litany of technological, regulatory, and market ways, many of which appear in lots of the testimony you've been provided with. And I'd add one to the list that came from the previous panel. It's very appealing, the idea of eventually moving to system of consumer subsidies where the consumer gets the subsidy, the ultimate person we're trying to help. But that is not technology neutral.

In a wireless world that works fine to give the customer the subsidy because wireless networks are not built to serve particular addresses and customers. They're served to -- they're built to serve particular areas that customers may travel through. Wireline technology is geared to specific locations. And if you give the customers the subsidy, you run into the problem that one person may want to use their subsidy for wireline and the next house down the road may not. But you still have to build the network down that road in any case. So, there are some important differences in technology that need to be recognized, and you can't do it through the equal support rule.

I don't think it is efficient to try to equalize wireless and wireline services. One of the wonderful things about them is they are so different. So, rather than try to say we're going to have the same standards and they all have to look the same -- they don't look the same. And I think the principle of competitive neutrality, or from the discrimination concept, would be that they should be treated differently. And by treating them differently, I mean that the wireless costs should determine wireless support. I have not seen a demonstration that wireless carriers in high-cost areas are, in fact, the same areas as high-cost areas for the incumbents. In fact, I think that quite possibly some of the urban areas are, in fact, higher cost areas for wireless carriers than rural areas. So, I think we need really need to have to a demonstration of where the costs are a barrier to achieving comparable services at comparable rates. And then that should be the basis for support.

I think we should also not mistake the intense competition for revenues and minutes for competition between the services. There is relatively little competition directly between wireless and wireline service for access. And, in fact, they are complementary to a great extent. In answer to the point raised about whether wireless carriers take as much out of the funds as they put into it, one the benefits wireless consumers get is the ability to reach anybody on a wireline phone by using their wireless service. And that was achieved largely through our universal service policies that built out the wireline network to reach everyone. So, they are benefitting even if they are not getting the same number of dollars out of the fund as they put in.

And, finally, I'd make two notes. One of them is that to the extent that there are allegations that the rural incumbents are inefficient, grossly inefficient, to me, that undermines any last reason why we should have equal support. I mean, presumably, if money is being wasted by the incumbents, why does a wireless carrier need the same amount of waste in order to compete? They simply don't have to waste it to begin with.

And the other point I'd make is that there is a sense of competitive sense of neutrality that is important and that has already come to past. And that is the competitive neutrality among wireless carriers themselves. We have a rural area in Alaska now where there are three wireless ETCs along with the wireline ETC. And it seems to me if you're going to provide high-cost support to one wireless carrier, you pretty much have to provide it to all, because they are competing directly for the same customers. And that, I think, enlarges the fund considerably.

COMMISSIONER ABERNATHY: Thank you very much.

Now, we'll hear from Dr. Lee Selwyn.

DR. SELWYN: Thank you, Commissioners. Glad to be back on this panel. I appreciate the opportunity to speak with you on this subject.

I was reviewing the statutory language and the statute that we've been talking about. The statutory language, let me just read it again: that customers in rural high-cost areas shall have access to telcommunications and information services that are reasonably comparable to those services provided in urban areas.

That to me implies that the policy that the Commission has been pursuing for 30-some-odd-years now of encouraging the development of competition, the policy that was adopted by Congress in the '96 Act, in looking to competition to support the telcommunications demands of this country, cannot be distinguished between non-rural and rural areas. If you develop and maintain a support system that in some manner limits the opportunities for consumers to benefit from competition in rural areas, then the statutory mandate is not being fulfilled.

Now, that said, let me speak about a couple of the specifics that are being discussed. First of all, let's talk for a minute about the equal support rule. My belief is that the equal support rule is absolutely essential to assure that consumers are confronted with efficient choices between and among various providers and various technologies.

Now, I actually find myself in agreement up to a point, which perhaps is unusual, with Dr. Lehman, as to the idea of carrying inefficiencies over from rural ILECs into CETCs. And the solution to that is to use as the basis for support the cost level of the most efficient provider. So, if the CETC is able to do it cheaper than the rural carrier -- or the rural ILEC than it is the CETC's cost and not the rural ILEC's costs that provide the basis for funding. So, we eliminate your concern about inefficiency and we eliminate my concern about a lack of competitive neutrality.

CETCs are carriers-of-last-resort. There is no proposal out there that suggests that any competitor that happens to wander into a particular rural community is immediately entitled to high-cost support. Carriers have to comply with the requirements of certification as ETCs, which includes a commitment to serve their communities ubiquitously. If multiple CETCs and multiple wireless carriers are certified as ETCs, that doesn't necessarily expand the size of the fund since the funding would be based upon the number of lines provided by each carrier. So, if three carriers divide up the wireless segment of the market, then the total draw would be essentially the same.

If you provide differential support based upon each carrier's costs or each technology's cost, you distort consumer choice, you distort investment choice. You discourage entry by lower cost -- inherently lower cost providers who are being forced to compete with subsidized higher-cost companies. That denies those customers in those communities access to competitive service.

Finally, on the issue of whether or not wireless and wireline are the same, first of all, the Commission, I think, needs to be consistent. If intermodal competition is to be viewed by the Commission as a general matter, as demonstrating the presence of competition in a market -- and certainly this has been raised in other areas in section 271 cases and the triennial review among other places, in broadband proceedings -- then you can't simply decide that oh, gee, in rural areas it's a different story.

Now, are they perfect substitutes? Absolutely not. No question about it. But they are economic substitutes and there is a price at which a consumer -- a price differential at which a consumer may be indifferent as between one or the other. If a price of a wireline service is $100 a month and then the price of a wireless service is $20 a month or $30 month, then there will be consumers who while preferring wireline service might decide at that point that the preference isn't worth the price difference. And that's exactly the kind choices we want consumers -- we want to encourage consumers to make. If we distort those choices by subsidizing wireline service to the tune of the difference between 100 and 30, that choice is eliminated.

No one is saying they are the same service, but they are at a certain level economic substitutes. And if intermodal competition is going to be a focus of Commission policy, you can't change the rules, as it were, in rural areas. It seems to me that rural, in order to establish a level playing field, to encourage efficiency, to eliminate the various perverse incentives in the present system that looking to provide an equal level of support for carriers based upon the most efficient carrier's costs is a reasonable policy approach. Thank you.

COMMISSIONER ABERNATHY: Thank you very much, Dr. Selwyn.

And now we'll move to the Q and A, we

will start with Commissioner Martin.

COMMISSIONER MARTIN: Mr. Johnson, I heard you state a -- I think I heard you state a fact that I wanted to follow up on. You said that 80 percent of the growth in the high-cost fund was not a result of CTEC growth. Is that -- could you --

MR. JOHNSON: That's correct. If you remember when we re-balanced rates, moved things from implicit cost to explicit cost, there was a dramatic increase in the high-cost fund. Since that was completed, however, something like 83 percent of the growth has been from CETCs. The fact is that for the last, I think, two years the total growth in the high-cost fund from incumbents is something like 3.1 percent.

COMMISSIONER MARTIN: And no one on the panel disagrees with that?

MR. JOHNSON: That's based USAC's numbers.

MR. COLE: I agree. The numbers that I used were 22 million and 110. And that is from 2003 to 2005 the projection by USAC. And some of the numbers have been used in the earlier time period. But if look at the growth between 2003 and 2005 projected, using USAC numbers, you look at the high-cost loop fund, it is basically the same percentage. 83 percent is the increase driven by CETCs.

MR. BERGS: I have to plead partial ignorance and then a little disagreement. I've got to admit, I don't know if we look at only the last two years. But if we looked at 2000 and 2003, 87 percent of the growth in the fund was attributable to ILECs.

MR. JOHNSON: That's correct. As I said, that was the period of time when we re-balanced rates and moved things specifically into the ICLS rates.

COMMISSIONER MARTIN: And then my next question was for Dr. Selwyn. I agree with you that the Commission ultimately has to be consistent in its approach on intermodal competition. I mean, that's an important point as we're trying to figure out how we're approaching this. And you're right, that has been raised in a series of proceeding including the TRO.

But it has also been raised in some

of the mergers that we've had in front us recently. And in that context, I think we've actually been more skeptical in our conclusions about the current substitutability of wireless per wireline service. So, does that have an impact in your comments today?

DR. SELWYN: In fairness I, myself, have been skeptical about the substitutability. So that nobody goes -- and I'm sure there will be people here who would go and try to dig out my prior testimony and say, see, he's being inconsistent. As I said, they are not perfect substitutes. But at a certain point they are economic substitutes.

I think that in particular in rural areas where we are confronting unusually -- what are alleged, at least, to be unusually high costs for wireline services, wireless may be a more viable technical economic substitute than in other areas. And we certainly want to encourage the exploitation of that technology if, in fact, that is true.

And then the last thing we should be doing is distorting that or discouraging investment. So, I absolutely agree that we are -- I don't believe they are perfect substitutes. I don't believe the market has -- in the mainstream market, despite attempts by certain incumbent LECs to portray it otherwise, I don't think the mainstream market has made that demonstration. But in particular in rural areas, the potential for -- as an alternative, as a lower cost alternative is real and certainly should not be distorted. And that's all I'm saying.

COMMISSIONER MARTIN: Thank you.

COMMISSIONER ABERNATHY: Commissioner Dunleavy.

COMMISSIONER DUNLEAVY: Thank you, Madam Chair.

Ms. Parrish, if we base the CETCs support on its own costs, are we assuming or just hoping those costs are lower than the ILEC's costs?

MS. PARRISH: Well, our proposal to base is its on own costs up to the amount of the ILEC costs. So, it would -- the support would also always be lower than or equal to that of the ILEC. I don't think you can assume that it's always going to be higher or lower. It's that it's going to depend on the area; it's going to depend upon the density and the build-out. It's that they have some of the same density issues that the wireline carriers do.

And, in fact, if you -- the other concern I have is that some of the suggestions that have been made that we base it on the model of the lower of the costs, whether it's wireline or wireless, is that I think that again goes to the issue of build-out and assuring that the build-out built in the model is sufficient to actually serve the entire service area. Because if you use the actual construction that's out there now, you might not actually be supporting enough coverage based on some of the wireline model descriptions.

COMMISSIONER DUNLEAVY: And one little follow-up. When you're talking about support of customer lines, you're talking about the primary line or all lines?

MS. PARRISH: Either way. I think -- because the model's generally built to a household, and the addition of one line or two lines in terms of the cost models doesn't make very much difference. Now, what we're seeing in terms of the current system where you have -- it's based strictly on the number of lines and the ported amount from the incumbent is you're seeing three and four lines in a household being supported, and that clearly doesn't have the cost basis because you don't have four times the cost to serve a household as you do for serving one. I mean, the math doesn't work. You don't multiply by four for every line into that same household.

COMMISSIONER DUNLEAVY: That being the case, how do we reconcile that? Do we need Mr. Johnson's workshops and teach people how to do that?

MR. JOHNSON: Well, I think you do. I think if you're going to take public money and if you have an obligation to provide a level of service that says that it's good public policy -- that you get public money to do that, then I think we have to develop a methodology for insisting that people justify what they're doing with the public money. If that means we have to develop workshops as a way of doing it, put the safe harbor plan in place that we recommended, first to allow that to happen so we can kind of stop this thing from growing any larger right now, yes. This is not easy, but it's doable. And it's a lot easier than a lot of things I have to deal with every day.

COMMISSIONER DUNLEAVY: Go ahead, Mr. Bergs.

MR. BERGS: I would just add that some of the proposals that you've heard today are that we ultimately move the support to an individual. In that environment that problem is solved, especially when the lowest cost provider sets the basis for the per customer support. At that point, you aren't concerned about overfunding either of the two carriers that's available.

And I'd just add -- and this kind of ties into this question as well as one of your earlier ones -- that even assuming that the growth in the fund has been of a result of the competitive ETCs in the last year, to distort that number, ultimately -- again, a customer is only going to have so many connections.

We're not going to end up in an environment where there is an unlimited number connections for every person in those high-cost areas. So, there's an inherit cap with the current mechanism if we base it on per lines. By allowing that, the only way to fund growth is in that environment. Once we have established a competitive environment and are funding the most efficient provider, is it more people move to those rural areas? I think most of us would agree that might be a good thing.

COMMISSIONER DUNLEAVY: Does anyone have a specific idea of how we verify that?

MS. PARRISH: Well, I mean, I can't lay out the details for you, but I think that one of our ideas is you have to look at affordability and comparability. And comparability, we've started looking at on a state level where you might have a $40 cellular phone bill that includes lots of bells and whistles. And to try and get it down to the comparable price of plain, old dial tone, you, you know, take $3 off for call waiting and $5 off for voice mail and so forth. And then you can start doing an apples to apples comparison of at least what the prices of those services are. And I think that you have to assume that there's some relationship between price and cost.

COMMISSIONER ABERNATHY: With regard to the growth of the fund being related to the CETCs, of course, it is because they didn't exist before. So, that's no great surprise. It doesn't really concern me, because they didn't exist before and so it would make sense that as we decided to embrace competition for rural America that in fact that would drive up the size of the fund.

The real question for me is, are we directing the funds in the right way at the right amounts? And as Ms. Parrish said earlier, I think instead of focusing on carriers with high costs, I think our focus should be on consumers in high-cost areas. And in some respects I think we would want to embrace lower cost technology, not embrace higher cost technology.

And so, that leads to me see if anyone wants to comment on one of the proposals that's been out there, which is you basically seek out a bid to serve that area and the one with the lowest cost bid -- this is what a number of developing countries are doing -- the one that comes in and says, I will serve this for the least amount of the subsidy, that's then what any provider gets who serves that area.

I've heard concerns about that, that, well, what about the folks who entered under the old regime and they're there and they've got embedded costs. But I'd like to hear some debate around that proposal.

DR. LEHMAN: I'm not sure what people would be choosing between. I mean, what kind of service are they going to get? They like their cell phone. They use it a lot of the time. They can't use it in their rural residence because the service doesn't reach there. So, when you face them with this choice and take the lowest bid, how are you going to educate them as to exactly what it is that they're getting for that choice?

COMMISSIONER ABERNATHY: Well, you have to have certain criteria that any vendor would have to meet. And we'd certainly addressed that, I think, at the FCC and in the Joint Board when we said, if you want to be an ETC, you have to have carrier-of-last-resort, you'd have to have certain obligations. So, I think you -- you'd have certain criteria that would have to be met.

So, let's assume for a minute that the technology -- let's say it's not wireless, it's some other technology. Assume that it could do that. Is this overall approach reasonable?

DR. LEHMAN: The house I used to live in in a rural area, you could not have gotten a bid from other than the existing wireline provider if you required that they provide service to my home. Now, that's not the way the current rules read. If you're going to write rules that say you must be able to provide this level of quality of service to where the person's residence is and it must work X percent of the --

COMMISSIONER ABERNATHY: ILECs today only have to serve based upon reasonable request. Even the incumbents don't have to serve anyone. So, you'd have the same test for the new provider.

Gene, do you want to talk about this or Scott?

MR. JOHNSON: Well, I'm just thinking about we have to be careful that we don't dismantle this marvelous telephone system we have in this country to do that. So, I'm a potential competitor and I come in say, you know, put out the bid in the area that you live in, your study area, I guess, that I'm going to bid to do this. And so now, maybe I already have a network in place; maybe I don't. But to be sure, the network probably is not as good as the existing network that's there. If that was true, we'd be losing customers right and left to wireless carriers that we're not. And I think that's probably true in general in rural communities. It's not like in urban communities where you're losing customers to wireless carriers. It's a secondary service not replacing the primary service.

So, the concern I would have is as they build this out, when do you cut the -- I have a lot of concerns, obviously -- but when do you cut the funding out to me? I've got embedded costs. I've got this compact I've entered into with regulators that's 100 years or more old, certainly goes back into the '30s. And all of a sudden you're going to pull this compact out and say, we're just going to leave you stranded. Well, what happens to my stranded investment when you do that in these variable areas?

And at the end of the day, more importantly, what happens to the rural customers when the company that won the bid doesn't perform? You see construction projects every day that are taken over my by a bonding company at great delay and cost many times to the owner because the low cost bidder just was not able to perform.

MR. BERGS: Actually, I agree with a portion of what Mr. Johnson said. I think that in a bid proposal what the Commission would in essence be doing is picking a point in time and identifying the most efficient carrier at that point in time. Maybe most efficient isn't even the right characterization. The provider who will generate the most value to the customer at that point in time.

And today, I believe in a lot of our areas, we are that carrier. It may be a slightly biased opinion, I admit. But I do expect that at some point in time another technology, either provided by us or another carrier is going displace CMRS technology as the most efficient. I'm afraid the bid proposal would limit the ability of new technologies to be easily entered into those high-cost areas.

However, if competition under the current mechanism is in place and portability is in place, customers will choose the most high-value service available in that market, thereby alleviating the need for the bid proposal. It will target support to the most high-value provider.

COMMISSIONER ABERNATHY: Okay. And then one quick follow-up is if -- let's assume for a second this approach can't work because of the distortions and you've got the incumbents with other prices and we said, all right, we're not going to try this bid proposal. We're going to continue to have ETCs, but we're going to ask them to somehow justify their support through some kind of proceeding. If we came up with a new way of justifying support, wouldn't it make sense then to apply it to all the carriers who are serving that area if you came up with a better way? That was our first panel. It was really how you figure out the amount of support. It sounds to me like it might be whatever methodology you come up with, you would apply it to both the new guys coming in as well as the incumbents. Does that make sense?

MR. JOHNSON: I think that's what we said in our filing is that we think essentially what is good for the goose is good for the gander. We believe the right way to do that right now is based on embedded costs, so we would suggest that the CETCs submit appropriate kinds cost models or cost studies of some kind, perhaps if there are average schedule type costs that could be developed in order to do that. We absolutely agree with that.

MR. COLE: I guess one of the things Mr. Bergs talked about, I think you mentioned also in the start of yours as far as not focusing on the company, focus on the people involved. And it may be a given, but just a moment to visit. I think it is important. I understand the purpose of the universal service fund is -- what it was meant to do versus what we may be doing now.

And I just happened to think while I was sitting in the back a while ago. I went to my parents' this weekend with my seven-year-old, just to take her there. And they live in a very rural area, much of what we're talking about. It's actually a CenturyTel area. I believe it does receive USF support. I went there and it's easier to visit my parents, and they live across the street from my grandparents, and my sister lives next door. And they live in several little houses right at the top of the hill. And they're probably the only houses within a mile of there. And you go past there about 50 feet and the road stops and you have dirt. And then there's about one house per mile after that.

But I think we talked about what has

changed since then. I remember when I was a seven-year-old and went up there and my grandparents were across the street. That was my first introduction to phone service. And I learned real quickly when the phone rang, and their house was no bigger than this area up here, that there was two different rings. When one of them rang, it was your grandparents and you answered the phone and said, hello. And when it was the other ring, it was her mother-in-law, my great-grandparents across the street. And when it rang, you just picked up real quietly and didn't say anything and handed it to your grandmother. That was my introduction to telephone service and party lines and what it is.

And then I go there this weekend and, you know, we've long ago done away with party lines. We have single party, all digital service in that area. My father has his Internet hooked up to our telco service and has that. I look at the things that universal service means for that community. They now have one-party service. They really couldn't have had that without that. They now have 9-1-1. The biggest challenge with 9-1-1 was not the technology, but it was coming up the a name for all the roads. So, we did that.

And then we had an ice storm there five years ago. We were able to stay in touch, but they were out of electricity for five years (sic). So, those are the kinds of things I want to talk about when you think about universal service.

At the same time, my father has a bag phone, a wireless phone that he's had for ten years. It's the same bag phone and I know I should have bought him one by now, but he's stuck on that bag phone. And so, he's had that same service for ten years. He can't really use it at home. He has to use it in the car between the old saw mill after the turn. He goes there and he can pick up service and between Monroe. But he could not use that as a substitute for his home.

However -- and that's where the struggle is because, again, assuming that there is a wireless ETC there, I'm not sure that it's not going to have the qualifications. I don't understand after a telco made that investment, made those commitments to that community, provided those services, if they're getting $10 or $20 of USF a month for that line, why should that bag phone that has been in that car for ten years -- as far as I know, any towers had been built in that time -- should also receive the same $10 or $20 a month?

COMMISSIONER ABERNATHY: I think I'm going to stop now, because I do want to give my colleagues time to ask questions. Thank you.

COMMISSIONER NELSON: I do want to welcome a former member of the Michigan Commission staff, Ms. Parrish, who used to work for us and did a great job many years ago.

I want to focus on rule 305, which is one of the issues that was teed up in this proceeding. And I know, Mr. Cole, you indicated you'd like to see the Commission amend that rule. But would you agree with Dr. Selwyn that the need for that rule goes away if we redefine rural to look at the geography as opposed to the individual characteristics of the carrier? And wouldn't that also mean that perhaps we wouldn't be getting premiums paid in the amounts they're being now for new territories because the acquiring carrier would be getting the same level of support as the carrier that gave up the territory?

MR. COLE: As far as Dr. Selwyn's proposal, I'm not sure I understand the complexities of it. But I will answer as far as to the premiums. I think at the same time there has been a not a lot of transactions in the last couple, three years. And I think that's a part of it. Again, are those premiums still applicable for those parties based upon current regulatory and cost environment within rural telcos?

Again, I think the purpose of the safety valve was to take a look at those markets that were acquired and say, are they the same level of service that we would like to see those markets? Have they have received the same attention that the urban areas have received? And if not, is there any incentive or anything we can do where those customers can get those same levels of service?

And I think that was the intent. I think it's important to note that. I believe as of this date, there has never been a dollar disbursed under the safety valve program because of this limitation. So, I think all we're saying is that is the intent. And I know in the properties we acquired we made significant investments to upgrade not only the loop and the plant, but also switching facilities. And I believe our customers saw definite improvements. And a lot of our investments were made in that first year because we felt it was so critical. And we made commitments to local mayors, and we made commitments to state regulators that we would improve that service. And we did it regardless of the fact that by spending those dollar in the first year we were, in fact, penalized because that set our base going forward and precluded us from receiving the same level of USF support.

COMMISSIONER NELSON: Dr. Selwyn?

DR. SELWYN: I want to make one brief

observation. The reference was made to switching. I find it really very interesting that the rural carriers feel an entitlement to support for switching. In the TRO the Commission concluded that CLECs, many of which are smaller and more geographically disbursed than some of the larger small rural carriers, are not impaired with respect to switching. CLECs are expected to go out and use risk capital and purchase switching equipment and are not going to have access to switching UNEs at forward-looking TELRIC prices because of the nonimpairment finding.

There are relatively few serious scale economies associated with switching that would be that particularly impacted by rural areas. CLECs have been confronting the problem having to connect exchanges located over communities -- located over very broad distances to a relatively small number of switches. And the Commission has found that that's an acceptable business model. And I am concerned about the notion that the ILEC, the rural ILECs feel that they have some specific separate entitlement with respect to switching costs that are being denied, in effect, to other providers.

MR. COLE: Just to clarify, I don't believe I made any statement that those switching costs should have been included in anything. I was only making that statement about us replacing switches because we had one state, the State of Wisconsin, as part of our acquisition. The Commission made it a requirement that we replace or that we provide -- there were a number of them that were there, and we were specifically required to replace those switches as part of the acquisition.

DR. SELWYN: But had rule 305 been amended as you were proposing, then the cost base would have been lower, and you would have potentially been able to receive some high-cost support based on that switching investment, if I understand correctly what the proposal is.

MR. COLE: I don't know that I'm qualified to address that one.

COMMISSIONER NELSON: Dr. Lehman.

DR. LEHMAN: Your question about the

acquisitions disappearing, if it were done by geography, there's one real concern about that. And that's that we should expect the fund to increase about tenfold. I mean, if you look at the California results where they do have the fund at the state level and the size of that fund, we have the RBOC territories that have a lot of high-cost territories in them that would then become eligible for high-cost funding.

And the problem that poses then is we can't tolerate a tenfold increase in the fund. So, what we'll do is we will then have to use a forward-looking model of some sort because that's the only model we can manipulate to get a level of costs low enough to sustain the existing size of the fund but extend it to all geographic areas.

There is some appeal to me, the idea that non-rural and rural carriers should be treated the same. If a customer lives in a high-cost area, who cares who their provider is? Except we can't ignore history. There has been a historical compact, if you like, struck where non-rural carriers have agreed to serve high-cost areas. And they have not asked for a re-doing of the funds so that they get the same treatment as rural carriers. So, they're still willing to do that. And I think really the best we can practically achieve is to try to facilitate the transfer of exchanges from those carriers that now consider it sort of a burden to carry this along to carriers that are willing to invest in those exchanges and make the service better. And it doesn't require the fund going up by a factor of ten; it doesn't require some arbitrary reduction in costs that can't be actually achieved by rural carriers.

COMMISSIONER NELSON: You would agree, though, that these carriers, you know, to be a burden for them, probably have a lower level of service than other rural carriers?

DR. LEHMAN: I think in many cases they do, yes.

COMMISSIONER DUNLEAVY: Dr. Selwyn.

DR. SELWYN: I'm not sure that characterizing the large RBOCs, for example, in terms of their high cost of exchanges is necessarily being a burden and that was the basis upon which they chose to divest them. They chose to divest those exchanges because they were able to do so and capture a premium value. The exchanges were worth more to the buyer than to the seller, which is typically why an economic exchange takes place. And until the funding mechanism was modified to provide those incentives -- until the regulatory structure was modified to allow carriers to earn revenues that -- and carry them below the lines so they don't get included in any reckoning of revenue requirement, those perverse incentives didn't exist.

We didn't see the Bell companies selling off high-cost exchanges until very recently. We didn't see it for the first, almost, 100 years. They were net acquirers, not divestors. And I'm not sure they ever considered the burden. It's just that the structure was changing and it became profitable to sell them.

MS. PARRISH: To speak to Wyoming's experience about sold exchanges is that Quest -- U.S. West sold 20-something exchanges ten years ago. They were not very high quality. They've become very high quality. But I think that there can be abuse in the system as well. So, that's the torn judgment that, has it hurt. Because we have at least one company that has essentially gold-plated that system since acquiring it. But the other 20 exchanges have just become nice, wonderful rural exchanges. So that's the problem is to avoid the gold-plating or the abuse.

COMMISSIONER NELSON: I have one more question for Dr. Lehman, and I promised I'd come back to this in the previous panel. This idea of indexing and if we agree that perhaps we have different levels of calculations of support for a rural carrier and a wireless ETC, could we not index both of those and perhaps move towards more harmonization of the two methodologies over time?

DR. LEHMAN: Yeah. The idea of indexing would have the same appealing characteristics for both sets of ETCs. The thing I would want to avoid is the equal level of support, because who knows if it's equal. In fact, I am willing to think that some wireless carriers might deserve more support than the current rural ILEC is getting, if they could justify what the investments are going to actually do and if some appropriate regulatory Commission looks at it and says, this is really something that's needed that's going to be provided. So, I don't think the levels of support should be the same, but capping them does provide incentives for cost reduction for both kinds of carriers.

COMMISSIONER NELSON: Thank you, Madam Chair.

CONSUMER ADVOCATE GREGG: Dr. Lehman, following up on that. If you believe that it is not proper to equalize support and that wireless and wireline technologies are different, do you think that the current support system for non-rurals, which provides equal per-line support to all ETCs is wrong?

DR. LEHMAN: Yeah. I think it's just as wrong as it is for the rural carriers, but it probably matters less since it's so much less support being collected by non-rural carriers. It's very concentrated where it is, and that's where you see competitive ETCs apply for that status.

And the concern that I would have is what demonstration do we have that the higher support -- that high-costs are what those wireless carriers are actually experiencing there, and that they're using the money to actually upgrade service there. So, that's all I would ask for is that they demonstrate their need for the support and their use for the support, whether it's a rural or non-rural territory.

CONSUMER ADVOCATE GREGG: Mr. Bergs, you stated that there was a natural cap on the amount of support that would be paid to support multiple lines in high-cost areas. Given that the projections for incumbent rural LECs for the first quarter 2005 on an annualized basis is for support of two and a half billion dollars, what level of cap would you think that we would ultimately reach if we allowed the fund to just continue to rise to its natural level?

MR. BERGS: Well, first of all, I want to clarify. The amount of support provided to a competitive ETC is what I think has a natural cap attached to it because, again, as each competitor enters a market, a consumer is only going to purchase one or maybe two lines. And, in fact, I believe that in the long run while it's been demonstrated, I think there's some agreement amongst the panel that wireless isn't currently accepted as a substitute for wireline. That number has increased over the last couple of years from an estimated 3 percent up to, now, an estimated 6 or 7 percent.

And over time -- well, first of all, the reason for that, I think, is wireless hasn't received funding in the past, and as a result hasn't been able to build the infrastructure required to avoid the antiquated equivalents of a party line only in wireless terms. So, I think in the long run you're going to have some more substitution and, in fact, you're going to see a downward turn in the overall amount of support.

I can't give you a number for where this is going to top out, but one way to control that is to maintain a cap or at least -- until we can come to a true portability of support from wireline to wireless, we maintain a cap on the wireline cost portion of the funds and allow CETCs to enter. As competition comes in, again, we can pick our number and we can create our multiplier, X dollars of per line support times two connections for every person living in that high-cost area.

And, again, one of the keys to reducing the impact of the current mechanism's ability to grow in the short term is to disaggregate that support. If we put it only in the high-cost areas, the only way that growth increases astronomically is if more people move into that highest cost area of a study area, breaking it into the zones has that inherent cap effect.

MR. COLE: I would comment on the concept of a natural cap if you have multiple wireless carriers within that. I guess I would disagree and maybe reference to some of the testimony that was in the pre-filed document that I had, where there had been situations of where there are more wireless subscribers on a billing list than there are population in the area. I mean, that's one wireless carrier. If you add multiple, that can happen.

I know this is similar to the article we talked about earlier. You're always going to have anomalies. You're going to have things that aren't done appropriately and don't make that rule instead of the exception. But I would point you to those references to say that under the current system that incentive exists.

In the past ten years -- or until about five years ago, I was in the wireless area of our business and was the president of our wireless operation for a couple of years. And I can tell you it was a constant challenge. When you have compensation programs, at that point for distribution, whether it be agents or others, that promote uneconomic things to happen, they're going to happen. The things you incent are going to happen. And if you incent funds based on customers on a billing list, that billing list is going to be higher probably than it should be, whether that's going to a bank in a metropolitan area that has 50 branches and 1 branch in the rural area. And the salesman says, hey, if you'll let me send all the bills to that branch, I'll give you a 10 percent discount. I'm not saying those things are happening but the incentive is there, and that is some of the risk you run with the current system that we have in place.

COMMISSIONER JABER: I thought it would be appropriate to end the questioning by delving into the logistical aspects of whatever gets implemented, and Mr. Johnson touched on that a little bit with regard to workshops. But the general question for any of you is that in determining what the appropriate methodology will be going forward and calculating support, what is the best procedural mechanism the FCC should use to adequately determine the best approach? And I'd ask, and you have already, to think outside the box of the traditional paper hearing that the FCC and the Joint Board uses. That's the first general question -- and not that there's anything wrong with that.

The second question relates to the

logistics associated with administrative expenses and what ongoing role USAC would have, and is there a mechanism that mitigates the concern as it relates to cost studies that get presented and USAC implementation going forward. Those are the two questions.

MS. PARRISH: Commissioner, as to your first question, in addition to any process that is used to come up with -- whether it's a form for the wireless submitting their embedded costs or a model for forward-looking costs, I think there should be some procedure prior to implementation but after development for parties to comment. It's that I think that when the non-rural model was developed there were a number of parties that late in the game said, wait, some of the inputs are wrong. But it was too late, really, to change it before it needed to be implemented. So, I think there needs to be to general-to-the-world opportunity to look at what has been developed and say, you know, here are the key inputs; you know, do these look right for your company or for your state. And so, I would offer that suggestion.

COMMISSIONER JABER: Anything relating to the USAC concern?

MS. PARRISH: My suggestion for USAC may be a little off point of this hearing, but one of the concerns I have has to do with the certification of the funds. I think that some of the -- I think I can speak for my own state, is that on the wireless certification it was simply a self-certification done by the carrier to the Commission, forwarded to the FCC. And there were some strong concerns about that self-certification. And I don't believe USAC is doing any auditing of those certifications at this point, and I understand resources issues and so forth. But, you know, in my ideal world, I think that the auditing or spot-checking of certifications would be a very useful thing.

MR. JOHNSON: I was to going comment on that second question as well. We've been told that USAC has been directed to conduct a number of audits of receivers of high-cost funds over the 2005 calendar year. And I understand they're gearing up to do that. And it struck me that if CETCs should -- you know, we develop a mechanism for CETCs to report their own costs and receive funds based on that, they ought to have a similar audit process. There's not going to be much difference in the process itself, you're obviously auditing different numbers. But you're not auditing a different process.

COMMISSIONER JABER: Dr. Selwyn.

DR. SELWYN: As to your first question, it seems to me that any carrier, whether it's an ILEC or a CETC, that is going to be relying on its own costs as a basis for support, should be required to provide information with respect to that if we're going to adopt any sort of embedded cost standard. And it's been suggested that CETCs should also provide embedded costs. I don't think that -- for reasons I've talked about that having a different level of funding for CETCs versus ILECs is appropriate.

In any event, if the ILEC funding mechanism is to be maintained, the support needs to be examined with respect to all revenue sources associated with that infrastructure, not just sources of revenue that are considered to be associated with local service. If the ILEC is capable of operating profitably with all it's revenue sources, it shouldn't be entitled to -- and support in whatever it does draw should be based upon the deficiency relative to all revenue sources.

I believe that going forward we should be looking at forward-looking costs that are not based on specific carrier costs, but are based upon model costs which reflect what would be expected from an efficient provider. And that should be the basis for funding all carriers. And that, in effect, gets us out of the rate case and auditing requirements. If a carrier wants and believes that it -- it confronts such extraordinary conditions that the model costs simply do not capture those conditions and it wants to make a case, then it should, in effect, make a revenue requirement case.

MR. JOHNSON: Can I make the comment, please, related to that? I heard in the earlier panel something that I thought was just blatantly wrong. And that is that rural

LECs are not -- no one is looking at their costs and therefore no one is -- they're just free to run wild.

I said the last time I appeared before you that we have lots of reasons to be efficient, not the least of which is we have competition in many of our operating areas. But at least one commissioner before me right now is a commissioner in a state in which we do business in which they do rate reviews quite often and look very hard at our cost studies and our separations and what we're actually doing and asks very, very difficult questions. So, this idea that somehow we're not being regulated as to rates and just allowed to run wild and rampant is just absolutely and patently false and absurd.

MR. BERGS: I'd just comment on the second question that you asked. If we move to a system where CETCs' support is based upon their own costs, not only are we taking away -- are we in fact motivating that CETC the same way we have historically motivated the ILEC to increase its cost in order to get more support, hopefully the net result being more infrastructure is developed, but even in an inefficient manner.

But beyond that, logistically, you are forcing an absolute duplication of an effort that we admittedly -- or I believe USAC admitted has not been historically been able to maintain. One of the comments I noted in the USA article that was referenced earlier is that USAC staff is simply unable from a manpower standpoint to do the kinds of audits that they would need to do. Now, what we would be asking them to do is double first, upfront the cost studies that they have to initially identify to create the basis for support and double an unattained level of audit to ensure that those funds are actually being spent appropriately.

MR. COLE: One thing I might -- just to your question, because I do -- it's a tough question to answer because I think it does entail a lot. I would say, though, that from my prior experience -- I did serve, I think, at one time on the finance committee at the CTIA when I was in the wireless business. And I know we endeavored at that time to try to come up with some standard accounting, some standard ways of recognizing the commissions and other things. Well, being involved in our partnerships and also in others, I think there is some pretty standard accounting methodology that would not make that an impossible task.

Also in a number of the rural service areas because of the way the incentives began are represented by separate rural service areas. Independent telcos and others have a separate set of accounting records, even for their specific area, not necessarily that service area, but at least more defined geographically. So, I do think it's possible, and I do think there is some consistency. And I think the analysis of costs would be possible. How to take that and equate that to USF support would be very challenging. Thank you.

COMMISSIONER ABERNATHY: Thank you very much to the commissioners on the joint board and also to the panelists. This was very, very informative for us. No doubt we will have many interesting debates as we go forward dealing with all of this. But I do appreciate all your time here, for your written submissions, and for your willingness to come there. So, with that, we are adjourned.

(WHEREUPON, the second panel concluded at 4:55 pm.)

REPORTER'S CERTIFICATE

STATE OF TENNESSEE
COUNTY OF DAVIDSON

I, MELISSA M. SCHEUERMANN, Court Reporter, with offices in Nashville, Tennessee, hereby certify that I reported the foregoing public meeting on HIGH-COST UNIVERSAL SERVICE SUPPORT FOR AREAS SERVED BY RURAL CARRIERS AND RELATED ISSUES by machine shorthand to the best of my skills and abilities, and thereafter the same was reduced to typewritten form by me.

I further certify that I am not related to any of the parties named herein, nor their counsel, and have no interest, financial or otherwise, in the outcome of the proceedings.

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MELISSA M. SCHEUERMANN
Associate Reporter
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State of Tennessee At Large.

My Commission Expires: 3/27/2005